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IN THE

Supreme Court of the United States

October Term, 1955

Circuit Court Nos. 4755-8, inc.

WESLEY F. MULLETT, Appellant,

vs.

WILLIAM J. KORTH, Individually and as Collector of Internal Revenue, District of Utah, Appellee.

FRANK J. MULLETT, Appellant,

vs.

WILLIAM J. KORTH, Individually and as Collector of Internal Revenue, District of Utah, Appellee.

HAROLD COMER, Appellant,

vs.

WILLIAM J. KORTH, Individually and as Collector of Internal Revenue, District of Utah, Appellee.

LEO WEIBEL, Appellant,

WILLIAM J. KORTH, Individually and as Collector of Internal Revenue, District of Utah, Appellee.

Petition for a Writ of Certiorari to the United States Court of Appeals For the Tenth Circuit

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Petition for a Writ of Certiorari to the
United States Court of Appeals
For the Tenth Circuit

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit entered in the above-entitled cases on February 8, 1955.

CITATIONS TO OPINIONS BELOW

The District Court for the State of Utah, Central Division, rendered no written legal opinion. The opinion of the Circuit Court of Appeals, printed in Appendix B hereto, infra p. 58, is reported in 219 F. 2d 732.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 8, 1955. (Supp. Tr. of R. 20 and 21). Rehearing was denied on March 16, 1955 (Supp. Tr. of R. 36). The jurisdiction of this Court is invoked under 38 U.S.C., Section 1254 (1).

QUESTIONS PRESENTED

I. Whether, in miscellaneous tax cases wherein fraud is claimed, 26 U.S.C., Section 3312 (b) excuses the Collector of Internal Revenue from complying with—

(a) The Administrative Procedure Act (5 U.S.C. Sec. 1001-1011);

(b) The procedure outlined in the Federal Register published pursuant to the Administrative Procedure Act.

II. Whether a trial court may deny a motion to strike and properly allow evidence on a fraud issue to be introduced over objection in an exise tax case wherein fraud penalties were assessed, when the circumstances constituting fraud were never pleaded with particularity under Rule 9 (b) FRCP and as previously so ordered to be pleaded by the court.

III. Whether a trial court may, in a tax fraud case, fail to require the Collector to prove fraud within the particulars pleaded by him, and instead require the taxpayer to disprove the fraud particulars alleged.

IV. Whether a trial court may, in a Retailer's Excise Tax case, where the legality and amounts of all deductions are accepted by the Collector, require that the taxpayer prove

(a) to the last dollar the exact amount by which the Collector's arbitrary and admittedly erroneous assessment exceeds the true amount due, by

(b) books and records impossible for the taxpayer to keep and which are not kept by other merchandisers in a similar situation.

V. Whether a trial court may,

(a) exclude offered testimony by the owner and operator of a business as to the accounting practices of that business, and

(b) exclude offered testimony by a Certified Public Accountant who has audited the books of that business, as to its accounting practices and of accounting procedures and facts generally, and

(c) substitute therefore its own version of "proper accounting procedures" by taking "judicial notice" of the same in comments during the trial and in its instruction to the jury, and

(d) deny the party the right to prove, by competent evidence, that the "judicial notice" so taken was erroneous.

STATUTES INVOLVED

The statutory provisions involved are: the 5th Amendment to the Constitution; 26 U.S.C. (1939-1953), Sections 275 (a), 276 (a), 874 (a), 874 (b) (1), 1016 (a) 1016 (b) (1), 1635 (a), 1635 (b), 3312 (a), 3312 (b) and 26 U.S.C. Sections 6501 (a) and (c) (1954); 5 U. S. C., Sections 1001-1011, inc.; Rules 9 (b) and 15 (b) of the Federal Rules of Civil Procedure, and Federal Register, Wednesday, September 11, 1946, Volume 11, No. 179 A-49, Section 601.6 (formerly 26 CFR 601.6, part 29; now 26 CFR 601.48-9). These are printed in Appendix A infra, p. 49.

STATEMENT

These petitioners brought suit in the United States District Court for the District of Utah to recover the amounts paid under protest for excise tax deficiency assessments. The jurisdiction of the District Court was invoked under Section 3772 of Title 26, and Section 1340 of Title 28, U. S. C.

Audits of petitioners' businesses were made in 1945. On December 8, 1948, Notices and Demands were served on them to pay deficiency assessments (which included fraud penalties and interest) giving taxpayers—small retail jewelers — ten days within which to pay the alleged deficiencies due under threat of distraint proceedings.

Petitioners paid the aggregate sum of approximately $63,000.00 for deficiencies assessed against each of them for the years 1942-1943-1944.

They thereupon filed their claims for refund, and, when no action was taken thereon, ultimately sued in the

U. S. District Court for the District of Utah on February 25, 1952, to recover the deficiency assessments paid. Petitioners suffered an adverse verdict and recovered none of the amounts paid.

From the time of the commencement of the audit up to and including trial proceedings, petitioners made repeated requests for hearings and conferences with the local agent, the chief of the miscellaneous tax division and Washington officials, but these requests were ignored during the entire time and no such opportunity was ever afforded. The Collector admitted — and the circuit court noted in its opinion (infra p. 67) that "This procedure was not complied with. The Collector, however, proceeded in reliance on Section 3312 (b) of the Internal Revenue Code of 1939. . . ."

The circuit court opinion does not make it clear, as relating to miscellaneous tax cases whether

(1) no procedure is required to be published in the Federal Register pursuant to the Administrative Procedure Act, for fraud cases, or

(2) if a procedure is so published to cover fraud cases, it need never be followed.

After these cases entered the federal district court of Utah, the Collector was twice requirred to amend his pleading of fraud to comply with Rule 9 (b). FRCP. Although he purported to comply as to 1942 and 1943, no effort was ever made to amend his pleadings as to 1944.

REASONS FOR GRANTING THE WRIT

QUESTION I

A. THE OPINION BELOW DECIDES AN IMPORTANT QUESTION OF FEDERAL LAW IN A MANNER DIRECTLY OPPOSED TO THE EXPRESS MANDATE OF CONGRESS, AND IN VIOLATION OF THE REQUIREMENTS OF DUE PROCESS.

5 USC Sec. 1002 (infra, p. 49) requires that every agency shall publish in the Federal Register the ". . . nature and requirements of all formal or informal procedures . . . and . . . substantive rules . . . and of general policy or interpretations formulated . . . for the guidance of the public. . . "

Section 1002 further states: "No person shall in any manner be required to resort to organization or procedure not so published."

The Bureau published its procedure relative to excise taxes in the Federal Register, Wednesday, Sept. 11, 1946, Volume II No. 179, A-49, Sec. 601, (26 Code of Federal Regulations 601.48 and .49) providing for three separate conferences before assessment of taxes with (1) the investigating agent, (2) the Agent-In-Charge of the Miscellaneous Tax Field Force in the area, and (3) the Washington office of the Miscellaneous Tax Unit. Prior to the Washington conference a 15-day letter must issue giving taxpayer time to file a protest and request the Washington conference. After such procedure the assessment can be made. After assessment and payment the procedure provides that the taxpayer may file a claim for refund. After notification of rejection of his claim, the taxpayer may sue for refund within two years from date of the rejection

notice. However, suit may not be brought in the Tax Court since it had and has no jurisdiction over excise tax cases.

None of the foregoing notices were received by petitioners nor were any of the foregoing conferences suggested or permitted, despite many requests by petitioners over a period of years.

If the foregoing procedure did not apply to excise tax cases involving fraud, then Section 5 USC 1002 was never complied with in this respect and the assessment would fail. On the other hand, if the procedure was published — as petitioners contend, then the Collector's failure to follow the procedure also voided the assessment under the Act (5 USC No. 1002).

Section 601.6 recited *"the Taxpayer is furnished with a copy of the investigator's report (except in situations of confidential nature such as a case involving fraud)* . . . and later states that ". . . *the amount of tax (together with any applicable penalties and interest)* is entered on an assessment list. . ." These references, which clearly exclude one single step in the proceedings in fraud cases, manifestly prove that the procedure was to apply to fraud cases. This is confirmed by the fact that the excise tax case of Vasco Call involving fraud penalties, was settled (pursuant to the above cited procedure) in the Appellate Division (to which the Commissioner delegated his conference jurisdiction and authority in excise tax cases by Com. Reo. No. 2, 52-2 C.B.). See affidavit in Appendix C.

The Vasco Call case involved alleged deficiencies in amusement tax (a Miscellaneous Excise Tax) for the years 1941 through 1945. It was investigated during the same period and by the same agent, as the cases now before

the Court. The corresponding income tax case (Tax Court Docket No. 27884) was settled by stipulation filed in the Tax Court, as were these taxpayers' income tax cases. Administrative procedure was followed in the Call case. Hearings at two levels were had before the case went to the Appellate Division, in Salt Lake City, where it was finally settled. The required letters of notice, granting opportunity to file a written protest and request for conference *before assessment,* was sent. A protest was filed and conference had. The settlement was agreed to *before* the assessment was made.

All this information was denied by the Collector to these taxpayers, who discovered it by laboriously checking 50,040 cases docketed in the Tax Court to see if any had a possible corresponding excise tax case. Although this parallel case, investigated by the same agent, was proceeding through the steps required by the Administrative Procedure Act and Federal Register at the same time that the present cases were being fought, the Collector has at all times concealed this information from the courts below, and asserted that the very procedure followed in the Call case was *not* the required procedure of the Bureau of Internal Revenue.

It clearly appears that there has been a denial of the equal protection of the laws in these cases, and a deliberate concealment of these very important facts from the courts. It is submitted that this, standing alone, warrants a summary reversal of these cases.

(The Call case was finally settled early in 1955, after proceedings before the circuit court in these cases, and was uncovered by present counsel only two weeks prior

to the filing of this petition. The Collector will not officially affirm or deny this information.)

B. THE ISSUE DECIDED IS OF EXTREME IMPORTANCE IN ALL TAX CASES, AND READS INTO THE ADMINISTRATIVE PROCEDURE ACT A BROAD EXCEPTION IN DEFIANCE OF A DECISION OF THIS COURT.

In order to avoid the requirements of the Administrative Procedure Act and the Federal Register procedure published pursuant thereto — which the Collector and the circuit court in its opinion (infra p. 67) readily admitted were not followed, the Court ruled that 26 U.S.C. 3312 (b) excused compliance in a fraud case.

26 U. S. C. 3312 (b) is an exception to the general statute of limitations rule set forth in 3312 (a), and cannot be read out of context. These sections are set out following:

Section 3312, Period of Limitation Upon Assessment and Collection.

Except in the case of income, estate and gift taxes—

> (a) *General Rule.* All Internal Revenue Taxes shall, *except as provided in subsections* (b), (c) and (d) *be assessed within* 4 *years after such taxes became due, and no proceeding in Court without assessment for the collection of such taxes shall be begun after the expiration* of five years after such taxes became due.
>
> (b) *False Return or no return.* — In case of a false or fraudulent return with intent to evade tax, or of a failure to file a return within the time required by law, the tax may be *assessed,* or a *pro-*

ceding in Court for the collection of such tax may be begun without assessment, at any time.

When the circuit court stated (infra p. 67) —

> "If under Section 3312 (b) he could bring a proceeding in Court without even making an assessment at anytime, or if he could assess a tax without notice, it follows that the requirement for a fifteen day letter to the taxpayer had no application . . ."

it was giving, as a reason for the rule excusing compliance with the Administrative Procedure Act and the procedure published pursuant thereto in fraud cases, the complete foundation and reason for a rule completely doing away with the mandate of the Administrative Procedure Act in all *non-fraud miscellaneous tax cases as well*, since both (a) and (b) contain identical wording for a proceeding in court without assessment for the collection of such taxes.

Section 3312 (b) of 26 U.S.C. is not procedural and was never published in the Federal Register, as would have been necessary to satisfy 5 U. S. C. #1002 of the Administrative Procedure Act. It merely adds additional time in which to make an assessment or to sue for collection and is what it claims to be — a part of a statute of limitation.

The case of *Wong Yang Sung vs. Mc Grath*, 339 U. S. 33 @ p. 41, 70 S. Ct. 445 @ p. 450, is directly opposed to reading exceptions into the Act:

> "One purpose was to introduce greater uniformity of procedure and standardization of administrative practice among diverse agencies whose customs had departed widely from each other. We pursue this no further than to note that *any exception we*

may find to its applicability would tend to defeat this purpose . . ."

Also, at 339 U. S. 45, 70 S. Ct.:

". . . It is the plain duty of the Courts, regardless of their views of the wisdom or policy of the Act, to construe this remedial legislation to eliminate, so far as its text permits, the practice it condemns."

And at 339 U. S. 53, 70 S. Ct.:

"We hold that deportation proceedings must conform to the requirements of the Administrative Procedure Act *if resulting orders are to have validity.*"

The circuit court's reasoning and rule is of even wider import; it applies also to income, estate, gift and employment tax cases. Section 3312 (a) of 26 U. S. C. is the same, except for the time limit, as Sections 275 (a), 874 (a), 1016 (a) and 1635 (a). All of these sections were combined under a uniform time limit in Section 6501 (a) of the 1954 Code. Section 3312 (b) is the same, except for the time limit, as Sections 276 (a) 874 (b) (1), 1016 (b) (1) and 1635 (b). All of these sections were combined in Section 6501 (c) (1) of the 1954 Code. The House and Senate committee reports on Section 6501 indicate that no change in the law was intended by the consolidation other than the changes in time limits. In short, according to the circuit court's analysis, 26 U. S. C. 6501 and its predecessors excuse compliance with the Administration Procedure Acts in *all tax cases.*

5 U. S. C. 1011 (infra p. 39) requires that "No subsequent legislation shall be held to supersede or modify the provisions of this chapter except to the extent that

such legislation shall do so expressly." If Congress intended that 26 U. S. C. 3312 (b) be an exception to the Administrative Procedure Act, then 26 U. S. C. 6501 should have expressly modified the Act. Since it did not, it can only be inferred that Congress never intended 26 U. S. C. 3312 (b) to be an exception to the Act. It is clear that the Administrative Procedure Act was specifically intended to modify the law and procedure existing at the date of its passage, rather than the reverse.

C. DUE PROCESS OF LAW HAS BEEN DENIED PETITIONERS.

Petitioners submit that the failure to follow the required statutory procedure in these cases is an extreme departure from the concept of due process of law under the Fifth Amendment to the U. S. Constitution, and at the very least calls for the invoking of this Court's discretionary power. These petitioners were forced to pay the assessments levied under threat of distraint more than 4½ years prior to trial and were denied the legally required hearings and conferences, notwithstanding their requests.

The case of *U. S. vs. Morton Salt Co.* (1950), 338 U. S. 632 @ p. 644, 70 S. Ct. 357 @ p. 364 states:

> "The Administrative Procedure Act was framed against a background of rapid expansion of the Administrative process as a check upon administrators whose zeal might otherwise have carried them to excesses not contemplated in legislation creating their offices. It created safeguards, even narrower than the constitutional ones, against arbitrary official encroachment on private rights."

The circuit court opinion stated: "It has also been held that an irregularity as to the procedure or time of making an assessment of a deficiency tax will not render the assessment void," (infra p. 71), citing two cases wherein taxpayers waived minor irregularities in procedure, both decided prior to the passage of the Administrative Procedure Act. Petitioners herein have at all times strongly objected to the denial of administrative procedure. The complete denial of required notices and of three separate administrative hearings is hardly a "mere irregularity." The income tax cases (Tax Court Docket Nos. 42473-4-5- and 7) of these petitioners, corresponding to these excise tax cases, built upon the identical method of "redetermining" sales figures and likewise accepting all of the business deductions claimed by the taxpayers, were settled in conference with the Appellate Division (after and notwithstanding the judgment in these excise tax cases) at about ten per cent of the assessment. This conference corresponds to the third level of conference required by excise tax procedure 26 F.C.R. 601.48 which was denied these petitioners.

The major difficulty in these court cases has been the great difficulty of teaching judges complicated accounting procedures and reasoning, which was not present in the Appellate Division conferences in the income tax cases, and would not have been present in the denied conferences in the excise tax cases. Had these excise tax cases been heard in conference as required, they would undoubtedly have been settled on the same basis as were the income tax cases. Denial of this hearing cost petitioners 90% of the amounts collected, and discriminated against them by refusing them procedure granted to others similarly situated, and was an arbitrary denial of due process.

QUESTION 11

The basic pleadings preliminary to trial in the lower court involve these petitioners' complaints and the appellee's answers, amended answers, and the amendments to the amended answers. These latter pleadings were made by the appellee pursuant to court order. However, the appellee filed and served amendments to the amended answers, as ordered, only for the years 1942 and 1943, omitting doing so for the third year involved, 1944. Both the amended answers and the amendments to the amended answers were required by the court in order that the defense of fraud should be pleaded in accordance with Rule 9 (b), FRCP.

A. THE OPINION OF THE CIRCUIT COURT RELATING TO PLEADING FRAUD CONFLICTS WITH DECISIONS OF OTHER CIRCUIT AND FEDERAL DISTRICT COURTS AND THE FEDERAL RULES OF CIVIL PROCEDURE, AND PASSED UPON AN IMPORTANT QUESTION OF FEDERAL PROCEDURAL LAW WHICH SHOULD BE DECIDED BY THIS COURT.

1. *The Pleadings and Rulings Thereon.*

When these actions came on for trial plaintiff made a motion to strike the defence of fraud for the year 1944 because the appellee had failed to comply with the court's order that the particulars of fraud be pleaded pursuant to Rule 9 (b); however, the court denied the motion and permitted appellee to introduce evidence relating to fraud for the year 1944. In so doing, and in denying petitioners' motion, the court stated: "Well, of course, we can amend these pleadings to conform to the proof after the proof is closed." (R. 146) At the same time the appellee's counsel stated and admitted that the omission put him in jeopardy for that particular year. (R. 146)

In its opinion the circuit court, making reference to the failure to plead fraud defensively, stated that (infra p. 69) "Appellants were not unduly surprised and suffered no prejudice for the year 1944, since the Collector's amended answers alleged certain of the facts upon which he relied in assessing the fraud penalties for the year 1944, and taxpayers had been supplied with certain of the data upon which fraud penalties for that year had been predicated . . . the evidence upon which the collector relied to establish fraud was introduced in evidence . . . pursuant to Rule 15 (b), Federal Rules of Civil Procedure."

The court further stated (infra p. 69): "If an amendment to the pleadings to conform to the proof should have been made, the Court of Appeals will presume that it is so made to support the judgment."

Petitioners submit that there is nothing in the record nor in the court's opinion that gives the slightest indication of what "data" was furnished or supplied to them upon which fraud penalties for 1944 were predicated. Further, it is submitted that the answer and the amendment thereto—assuming they actually set out some facts relied upon to establish fraud for the year 1942 and 1943—certainly furnished no help against what petitioners contend were actual matters which did surprise and prejudice them.

In its opinion the circuit court made an attempt to decide what was in the mind of the jury. It acknowledges that part of the allegations constituting fraud were never pleaded, but takes the unusual position—despite Rule 9 (b) —that a partial pleading is sufficient. In its opinion specific reference is made to the following points as being

important in making the decisions: (1) fragmentary records, (2) the sales during subsequent years were greater than those in the three years in question, (3) bank deposits did not correspond with income reported, (4) the inventory for subsequent years were greater than the 1944 inventories, (5) discrepancies in the cost of merchandise purchased during the year 1944.

It is interesting to note that the foregoing references to the year 1944 were considerably greater than those to the prior years involved, and that none of these were pleaded with particularity for any year. Notwithstanding the argument and position of the circuit court, it is just as logical to argue and assume that the evidence introduced as to the year 1944—as to which no fraud pleading can be found—probably carried such a great weight in the jurors' minds as to create an impression of fraud that carried to the other two years. As to those particular items there was no pleading and no opportunity whatsoever to prepare to meet the surprise nature of the evidence, particularly when one considers that the inventory figures of the tax payers were accepted by the investigating agent as the very basis and beginning point for his computations.

Prior to the trial the petitioners served upon appellee a request to answer certain interrogatories, one of which related to the method used by appellee in determining "corrected taxable sales" for 1942 and 1943 as shown in his "Amendment to Amended Answer." (R. 33). The answer to this interrogatory stated in effect that to the total cost of goods or merchandise sold during each of the two years was applied the average "mark-up" used in each of the two years. "This computation gives the total receipts from the sale of goods based upon said mark-up." (R. 34)

The foregoing constituted nothing more than a "method" of computing the alleged tax due. This method is mathematically false, and any pretense it may have had to respectability was destroyed when the circuit court stated (infra p. 62): "We think that we may take judicial knowledge that shrinkage does occur in all merchandising businesses." In so stating, the court effectively admitted that the appellee not only failed to allege fraud in his amendment to the amended answer, but that he failed to plead any case at all. Since the appellee based his case upon the foregoing "method," as reflected in his answers to interrogatories, it is submitted that the petitioners would have been justified in disproving the method used without proceeding further. It is submitted that introduction of evidence under other approaches to proving fraud was highly prejudicial and constituted surprise in view of the pleadings setting forth nothing more than a "method."

The effect of the circuit court opinion allows a decision to stand without any legal underlying pleading and without pleading of any fraud in any manner whatsoever for the year 1944. A careful analysis of all pleadings shows that no particulars were pleaded beyond the "method" for any years, including 1942 and 1943.

2. *The Applicable Rule of Civil Procedure.*

Rule 9 (b) of the Federal Rules of Civil Procedure states:

> "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity."

Since the circumstances of fraud constituting fraud were not pleaded with particularity for 1944, the court at-

tempts to fall back on Rule 15 (b) to justify allowing evidence on the issue to come in at the trial. However, Rule 15 (b) was certainly never designed to allow evidence to come in on a fraud issue never pleaded. Rule 9 (b) was specifically inserted to afford a litigant the opportunity to prepare a defense against the serious charge of fraud. That rule stems from the old equity rules requiring particulars of fraud to be included in the bill. Further, the same rule has been carried forward into Tax Court procedure and rules of practice. Rule 9 (b) is a specific statutory feature, while Rule 15 (b) is a general rule. If Congress had contemplated that Rule 15 (b) should operate so as to permit an amendment to conform to the proof in a fraud case, or if this court should so rule, then there will be no reason whatsoever for retaining Rule 9 (b) in our Federal Rules of Civil Procedure since its application will become valueless.

It is submitted that a ruling is necessary as to the applicability of Rule 9 (b) in tax fraud cases. It involves a very important point of federal law undecided by this Court, which goes straight to the heart of due process. Further, there is an apparent cleancut split of authority between this decision of the Tenth Circuit Court and other circuit and federal districts in the United States.

3. *Conflicting Court Decisions.*

Rule 9 (b) of the F.R.C.P. stems from the old established equity rule set out in *Knox v. Smith* (1846), 4 How. 298, 11 L. Ed. 983, and *Very v. Levy* (1851), 13 How. 345, 14 L. Ed. 173, which required that "The fraud, with the facts connected with it," must be pleaded, and that the bill must charge "in what the fraud consisted." A modern

case stating the equity ruling is *Zoring v. Strauss* (1929), FCCA, 30 Fed. 2d 313, "When relief is sought in equity on the ground of fraud, a case for relief must be fairly made by the bill and answer, and the relief accorded must be such as follows legitimately from the pleadings and proof in conformity with the case alleged, and general averments of fraud are wholly inadequate and insufficient. This does not mean that all the details of fraud shall be set forth with particuarity. It is enough if the allegation is explicit and distinctly made and the method of is accomplishment pointed out . . ." On this base the opinions dealing with Rule 9 (b) have been built.

In the 9th Circuit are found *Sacramento Suburban Fruit Lands Company v. Stern* (1929), 36 Fed. 2d 928 (instruction requested to the effect that plaintiff could only recover upon proof of the specific false representations pleaded and not for other false representations, was refused by the trial court, and the case reversed on appeal because of that refusal) and *Yuen Boo Ming v. U.S.* (1939), 103 Fed. 2d 355 (It is elementary that even in ordinary civil suits the use of the words 'fraudulently obtained' does not charge a fraud. This phrase states a conclusion which may be satisfied by facts describing one or another of a score of possible frauds . . . a fortiorari is this absence of pleaded fact a violation of our concept of 'due process' where the complaint is made the basis of a warrant of arrest issued without a hearing . . .").

In the 5th Circuit are found *Bensinger v. Margaret Ann Super Markets* (1951) ,192 Fed. 2d 458 (summary judgment sustained where only general allegations of fraud were made, without the required particulars under Rule 9 (b)) and *Voliva v. Bennett* (1953), 201 Fed. 2d 434

(dismissal without leave to amend sustained on appeal, because "it is to the facts, rather than to the conclusions alleged, that we must look in determining whether, if proven, they would support recovery. When these are looked to it will be found that, instead, as required by . . . 9 (b) . . ., of alleging facts consisting fraud, the complaint contains only conclusions . . .").

In the 4th Circuit is found *Owen v. Commercial Union Fire Insurance Company* (1954), 211 Fed. 2d 488: ("We think, also, that no sufficient findings of fact have been made by the trial judge to constitute the basis of adequate review. He merely states generally in his oral opinion that the plaintiff did not tell the truth with respect to certain matters, without finding what false statements were made by plaintiff, when they were made, wherein they were material or in what respect they were false. The omission to make specific findings was not alleviated in any way by the record; for the allegation of fraud and false swearing was in the most general terms without any designation in the pleadings or otherwise of what representation were claimed to constitute a violation of the policy provision, or wherein they were claimed to be false and material. This was clearly a violation of rule 9 (b) of the Rules of Civil Procedure which provides that 'In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity.' The circumstances constituting fraud or swearing were not alleged in the pleadings nor were they set forth in the opinion of the court. The judgment appealed from will accordingly be vacated and the case will be remanded with direction to the court below to require the defendant to specify the false and fraudulent statements upon which

it relies for the avoidance of the policy, to allow the parties to produce such additional testimony as they may desire and then to find the facts specifically and enter judgment thereon in the light of the rule that the burden of proof rests upon the defendant to establish the fraud and false swearing upon which it relies.")

Among the district court opinions of record are found *District 65, Distribution, Processing and Office Workers Union of New York and New Jersey v. McKague* (1953), D. C., W. D. of Pa. 115 F. Supp. 227 (complaint dismissed unless plaintiff amends to alleged fraud in compliance with Rule 9 (b)), *Crummer Co. v. DuPont* (1954), D. C., N. D. of Fla., Tallahasse Div. 117 F. Supp. 870 (complaint dismissed because statute of limitations not tolled by allegations of fraudulent concealment which were but conclusions of law not sufficient under Rule 9 (b)), *N. Y., N. H. & H. Railway Co. v. New England Forwarding Co.* (1953), D. C., R. I. 119 F. Supp. 380 (statute of limitations not tolled because fraud not pleaded according to Rule 9 (b)), *Nutrena Mills v. Greer* (1953), D. C., S. D. of Mo., W. Div. 114 F. Supp. 156 (motion for summary judgment granted where defendant's affidavits in opposition to motion did not portend ability of defendant to comply with Rule 9 (b) as to circumstances constituting fraud), *Zimmerman v. National Dairy Products Co.* (1939), D. C., S. D. of N. Y. 30 F. Supp. 438 (complaint dismissed for failure to plead facts constituting fraud instead of mere conclusions of law), *Mayflower Hotel Stockholders v. Mayflower Hotel Corp.* (1947), D. C., D. C. 73 F. Supp. 721 (no cause of action stated where Rule 9 (b) not complied with), *Ivey v. Housing Foundation of America* (1947), D. C., M. D. of Pa. 73 F. Supp. 201 (no cause of action stated where Rule 9 (b)

not complied with, *Statler v. Babcock* (1946), D. C., W. D. of Pa. 7 F. R. D. 57 (statute of limitations not tolled because fraud not pleaded with particularity under Rule 9 (b), and action dismissed), *Hoover v. Lacey* (1943), D. C., D. C. 80 F. Supp. 691 (summary judgment for defendant where complaint failed to comply with Rule 9 (b)), *Seward v. Hammond* (1948), D. C., Mass. 8 F. R. D. 457 (action dismissed because "it is not sufficient merely to allege . . . that the defendants' business operated as a fraud and deceit upon the plaintiffs . . ."), *Paramount Textile Machinery Co. v. Burlington Mills Corp.* (1950), D. C., Del. 90 F. Supp. 66 (answer alleging that defendant's predecessor induced to enter license agreement with plaintiff by misrepresentations and that plaintiff induced defendant to continue such agreement by misrepresentations, striken for failure to allege circumstances constituting fraud or mistake), *Producers Releasing Corp. v. Pathe* (1950), D. C., S. D. of N. Y. 10 F. R. D. 29 (counterclaim dismissed for failure to comply with Rule 9 (b)), *Decorative Cabinet Corp. v. Stor-Aid of Ohio* (1950), D. C. S. D. of N. Y. 10 F. R. D. 266 (defendant's motion to strike for failure to comply with Rule 9 (b) granted), *Gilbert v. Clark* (1952), D. C., Mass. 13 F. R. D. 498 ("Each defendant, . . . is entitled to be apprised of the circumstances constituting the alleged fraud . . .," allegation stricken), and *U. S. v. St. Louis Clay Products* (1943), D. C., E. D. of Mo. 3, F. R. D. 289 ("Defendants should be advised with particularity of the circumstances constituting the fraud, so that it can be determined *which* of the books, records and papers concern the fraud alleged in the complaint.")

Due process of law contemplates notice and an opportunity to be heard. The Collector's failure to comply with

Rule 9 (b) completely deprived petitioners of any notice, and prevented them from having a fair hearing wherein they could refute the evidence introduced. None of the courts above cited countenace such a violation of the 5th Amendment, as does the opinion herein.

B. THE OPINION BELOW IS INCONSISTENT WITH ITSELF, PAYING LIP SERVICE TO ESTABLISHED LAW, BUT IN FACT CONFLICTING, AND VIOLATES ESTABLISHED CONCEPTS OF PROCEDURAL DUE PROCESS.

1. *Accounting Statement*:

For a thorough understanding of the basic issue on the merits of these cases, which is a prerequisite to a comprehension of the errors regarding pleading, burden of proof, evidence, judicial notice and instructions, some accounting background and explanation is essential. A detailed analysis, completely supported by accounting authority, will be made in the brief, if permitted. The space needed for this material is so great as to preclude its reproduction here, so this petition merely states the results of this accounting analysis and briefly outlines the facts. Petitioners most earnestly request the opportunity of presenting the detailed proof of their case for this Court's consideration.

Petitioners basic case rests upon a fundamental accounting error made by the Collector in setting up the assessment, on which his pleadings and arguments were based. and which can be mathematically demonstrated to be false. This error was proven to the circuit court and acknowledged by it, but the necessary corollaries were not understood by that court. They are, nevertheless, just as capable of mathematical demonstration as was this basic error itself, but require more attention and analysis.

Each petitioner valued his inventory on the "lower of cost or market" basis, as authorized by the Internal Revenue Code and Regulations 118, Paragraph 39.22 (c)-4 (d). (R. 130). This resulted in the automatic inclusion of "shrinkage" losses in Cost of Merchandise Sold.

"Cost of Merchandise Sold" is a conventional accounting term meaning the result of the mathematical computation "Begining Inventory plus Merchandise Purchase less Ending Inventory" (see Schedule C. Form 1040), and is therefore something of a misnomer. It is not the same as the "cost of merchandise actually sold" at all. This latter term means the total of the inventory costs of all the items of merchandise actually sold to customers during an accounting period. It differs from "Cost of Merchandise Sold" by the total of the inventory costs of all those merchandise values which have left the stock-in-trade during the accounting period by means other than sale to customers; ie., by the "shrinkage" losses.

"Shrinkage" is:

> the amount by which Cost of Merchandise Sold exceeds the cost of merchandise actually sold (*Finney and Miller: Principles of Accounting - Intermediate (4th Ed.), p. 356 - Lost Costs, p. 399-first paragraph*) (*Kester: Principles of Accounting (4th Ed.), p. 101 - Verification of Perpetual Inventory*). i.e. The amount by which total "mark-up" exceeds Gross Profit. Also in a business using "perpetual" inventories, the excess of the total "perpetual" inventory over the total of the actual physical inventory (*Dohr, Ingrham, Love: Cost Accounting Rev. Ed.*) p. 170 - *first paragraph*) *Reitell and Johnston: Cost Accounting* (*2nd Ed.*) p. 82

¶ 66, p. 90 ¶ 73, p. 92 ¶ 74, p. 94 - last paragraph). Shrinkage includes:

(1) incoming freight, express and postage, and other costs necessary to making the merchandise available for sale (which are included in Purchases but excluded from inventory, and are therefore included in Cost of Goods Sold but excluded from the cost of merchandise actually sold) (*Finney and Miller*: *Principles of Accounting-Intermediate* (*4th Ed.*), p. 84-*Freight on Purchases*) (*Kester*: *Principles of Accounting* (*4th Ed.*), p. 100-*Objections to Perpetual Inventory*).

(2) items of merchandise which have been available for sale but which have been eliminated from the stock-in-trade by means other than sale (such as goods lost, stolen, used in advertising or in making repairs, damaged or defective and thrown out, etc.) (*Finney and Miller*: *Principles of Accounting-Intermediate* (*4th Ed.*) p. 356 — *Lost Costs*, p. 386-*Obsolete and depreciated merchandise*, p. 399-*first paragraph*) (*Kester*: *Principles of Accounting* (*4th Ed.*), p. 100-*Objection to Perpetual Inventory*);

(3) values which have been eliminated from the inventory by "markdowns" from invoice cost to market cost, and are therefore included in Cost of Goods Sold (*Finney and Miller*: *Principles of Accounting-Intermediate* (*4th Ed.*) p. 386-*Obsolete and depreciated merchandise*) (*Kester*: *Principles of Accounting* (*4th Ed.*) p. 577-*last paragraph*) (*Kester*: *Advanced Accounting* (*3rd Rev. Ed.*) p. 145).

That shrinkage necessarily occurs in all merchandising businesses was demonstrated to the circuit court, which said (infra p. 62) "We think we may take judicial knowledge that shrinkage does occur in all merchandising businesses."

The Collector's method of computing "redetermined sales" was founded upon the assumption that shrinkage did not exist in the businesses of these petitioners. The circuit court said (infra p. 62) "It is obvious that this method was erroneous to the extent that it did not allow something for shrinkage," but completely failed to appreciate the enormous effect of this error.

The Collector added to each petitioner's reported Cost of Goods Sold figure the amount which resulted when he "took the cost of goods sold as reflected by the books of appellants and applied thereto a mark-up percentage which was obtained from an examination of the sales tickets" (infra p. 62), which total he called "redetermined sales." "Mark-up" as used in the record means the amount by which the retail selling price (not including taxes) of an item exceeds the inventory cost of that item, and the "mark-up percentage" referred to by the court was the percentage determined by dividing the total of a large number of individual "mark-ups" by the total of the corresponding inventory costs. The figure obtained by multiplying Cost of Goods Sold times this mark-up percentage is meaningless from an accounting standpoint, and might just as well have been the total bonded indebtedness of the State of Utah. This arbitrary figure was used by the Collector as though it were a Gross Profit figure. It exceeded the true Gross Profit figure by an amount equal to the shrinkage times the mark-up percentage used. The Col-

lector's method treated the entire shrinkage losses as (instead) having been sold to customers at inventory cost plus the average mark-up, thus greatly inflating sales.

The correct approach would have been to apply to the Cost of Goods Sold a "gross profit percentage on cost." This latter expression means the percentage obtained by dividing Gross Profit by Cost of Goods Sold.

"Average mark-up percentage" exceeds "gross profit percentage on cost" by an amount equal to the shrinkage percentage times the sum of average mark-up percentage plus one hundred percent. This means that at an average mark-up of 130% (used by the Collector herein) the average mark-up percentage would exceed the gross profit percentage on cost by 230% times the shrinkage percentage. Thus, a comparatively small shrinkage resuts in a wide difference between mark-up percentage and gross profit percentage on cost.

The Collector used the mark-up percentage as a gross profit percentage (R. 399, 401, 403, 405, 407, 413), completely ignoring the existence of shrinkage.

2. *The Collector's argument and pleading.*

The Collector believed, pleaded and argued that the difference between the Cost of Goods Sold figures as reported by petitioners, and the total inventory cost of the merchandise actually sold over the counter as determined from sales ticket analyses, was proof of a fraudulent understatement of sales. For example, in the Collector's opening argument appears the following (R. 101):

> ". . . with respect to the Leo Weibel case, we think that from available sales tickets we can show

> that the average mark-up was about 92 per cent; that in 1942 of the available sales tickets in that year, the cost of the goods sold is about $3,000, whereas the books of Wayne Decker . . . show that for that year the total . . . cost of the total sales of merchandise was $800 more than the sales tickets themselves show. We believe that that will evidence, of course, an understatement of sales and a failure to make sales slips on all of those sales; therefore, in computing the total sales . . . the agent . . . applied the average mark-up which he computed from the sales tickets . . . to the cost of the merchandise which . . . shows in his books . . . and in that way computed the additional tax which he felt should have been paid."

The sales "ticket costs" show only the "inventory costs" (the lower of "invoice cost" or marked-down to market "costs") of the merchandise *actually sold* over the counter. The $3,000 referred to by the Collector was the total of the "ticket costs" of those tickets which had been marked in code. Those "ticket costs" cannot show the shrinkage losses which are not sold but which are included in the total Cost of Goods Sold figures—in this case $3,882 (R. 293). The totals of the individual sales "ticket costs" differ from the Cost of Goods Sold figures shown on the books by the totals of the shrinkages — in this case about $800, or 20.8% of the Cost of Goods Sold. That the total of the sales "ticket costs" are $800 less than the Cost of Goods Sold shown on the books is not evidence that sales were understated at all, as the Collector "of course" believed, but is evidence that the shrinkage was $800. In applying the average "mark-up" percentage to the total Cost of Goods Sold of $3882, the Collector charged the taxpayer with the sale of that $800 shrinkage loss at a sales price of

$1,536 ($800 + 92% of $800). How could the taxpayer make out sales tickets for the sale of stolen goods, freight and postage, obsolescence, and the other shrinkage losses which could not be sold? The Collector in this opening statement has said that the additional tax has been computed on the sales of the $800 difference (shrinkage), and that the taxpayer's failure to make out sales tickets on these impossible "sales" is "of course" evidence of fraud.

The Collector, however, based his entire pleadings on that false premise. The trial court recognized that the original answers and amended answers did not plead fraud in accordance with Rule 9 (b) of the Federal Rules of Civil Procedure, and ordered further pleadings (R. 8, 20, 27, 42, 49, 65, 72, 84, 91). The Collector complied as to 1942 and 1943 only, and filed his Amendments to the Amended Answers (R. 38, 50, 72, 92). The only particulars added by these pleadings are the allegations concerning average mark-up percentages and their application to Cost of Goods Sold figures to "redetermine" Gross Receipts, together with the assertion that no sales records had been kept for the alleged additional sales resulting from the "redetermination," plus (in the two Mullett cases only) the allegation that the taxpayers' breakdowns of total Cost of Goods Sold into Cost of Merchandise Sold and Cost of Repairs, were false and fraudulent.

Nowhere in any of his pleadings does the Collector allege: (a) specific unreported sales, (b) unaccounted for increases in net worth, (c) unaccounted for bank deposits, (d) absence of specified books and records other than the sales records for the alleged additional sales resulting from his "redetermination," (e) missing inventory records or false inventory valuations or totals, (f) any comparisons

between the years in controversy and subsequent years, (g) any necessary relationship between the admittedly arbitrary Cost of Goods Sold breakdowns of the Mulletts and the correct Gross Receipts figures, (h) any gross profit percentages, (i) any shrinkage amounts, percentages or computations, or (j) any facts whatever constituting the alleged fraud. He has pleaded a mathematically impossible conclusion as his particulars of fraud, and nothing more.

3. *Taxpayers' position.*

The petitioners do not contest the amount stated in the Collector's pleadings to be Cost of Goods Sold; they are petitioners' own figures taken from their books and records and tax returns. They do not contest the average mark-up percentages used by the Collector; they are computed from petitioners' own records, and differ from petitioners' own computations by insignificant amounts. But the fact that multiplying the Cost of Goods Sold by the average mark-up percentage and adding the result to the Cost of Goods Sold figures gives a result higher than a petitioner's Gross Receipt figure is no ground for belief that fraud occurred; this is a normal and necessary result of the shrinkage that occurs in every merchandising business. The use of an average mark-up percentage instead of a gross profit percentage on cost requires an additional statement as to the shrinkage percentage before the computation and allegation has any significance. No mention of shrinkage was made. The specifications of fraud do not state a contestable issue, and leave the petitioners with nothing to defend against, except to show that the Collector's method is erroneous (which is obvious on its face to anyone with an understanding of accounting).

The circuit court recognized that the Collector's method was erroneous because it omitted consideration of shrinkage, took judicial notice that shrinkage did exist, but ruled: ". . . it does not follow that a reversal must follow therefrom . . . Appellants completely failed to establish by competent evidence the amount of shrinkage incurred in these businesses. They had no records or factual testimony showing shrinkage losses . . . If a taxpayer's books failed to reflect certain essential facts, he must suffer the consequences. . . ." (infra p. 63).

Petitioners contend that this ruling was erroneous because:

(a) the Collector's pleadings fall empty once his method is found false (which the court's acceptance of the fact of shrinkage so finds), and the ruling squarely conflicts with the applicable decisions of other circuit courts of appeals and with federal district court opinions, listed above, on the pleading of fraud;

(b) the ruling fails to require the Collector to prove fraud within the particulars pleaded, since it does not require him to show that the shrinkage was less than that computed from petitioners' figures, or anything at all regarding shrinkage, but places the burden on petitioners of disproving fraud by establishing the correct shrinkage figures, which ruling squarely conflicts with the applicable decisions of other circuit courts of appeal;

(c) the ruling decides an important question of federal law (burden of proof in excise tax cases), not heretofore decided by any court, in a way conflicting in principle with analogous rulings of this court, other circuit courts of appeal and the tax court; and

(d) the ruling requires the petitioners to prove their case through records and testimony impossible to obtain, which other merchandisers similarly situated do not and cannot obtain and therefore arbitrarily discriminates against petitioners and denies them due process.

QUESTION III

In the 9th Circuit are found *Ohlinger v. U.S.* (1955), 219 F. 2d 310, 55-1 USTC 9214 (the Collector has the burden of proving fraud in a suit for refund) and *Sacramento Suburban Fruit Lands Co. v. Stern* (1929), 36 F. 2d 928 (proof of fraud required to be within the particulars pleaded).

In the present cases, the Collector was permitted to introduce evidence on fraud outside the particulars pleaded, and was never required to establish that actual shrinkages were less than that computed from petitioners' figures, which was the essential part of the fraud particulars pleaded (See IIB„ supra).

Instead, the taxpayers were required to disprove the fraud charge by proving the exact amount of the shrinkage, notwithstanding the fact that the shrinkage had been accepted by the Collector when he accepted the Cost of Goods Sold figures of petitioners, since they were a necessary part thereof, and that the taxpayers had no notice that the Collector was going to contest the amounts thereof.

This opinion conflicts with the 9th Circuit rule of the above cases, and is a violation of due process in that it permits surprise and lack of notice on a fraud issue.

QUESTION IV

A. THE COURT BELOW DECIDED AN IMPORTANT QUESTION OF FEDERAL LAW NOT HERETOFORE DECIDED BY ANY COURT, IN A WAY CONFLICTING IN PRINCIPLE WITH RULINGS OF THIS COURT, OF ITSELF AND OF THE TAX COURT IN ANALOGOUS CASES, AND WITH THE PRINCIPLE OF DUE PROCESS.

This is the first Retailer's Excise Tax case in any circuit wherein a general burden of proof ruling has been made.

The analogous rule in cases taken to the Tax Court is that once the Collector's determination and method are shown to be erroneous, the burden falls upon the Collector to establish a valid method of assessment. *Helvering v. Taylor,* 293 U.S. 507, 55 S. Ct. 287, 35-1 USTC 9044, *Federal Bank of Shawnee v. Commissioner,* 180 Fed. 2d 294 (CCA-10), 50-1 USTC 9184, *A. & A. Tool & Supply Co. v. Commissioner,* 184 Fed. 2d 300 (CCA-10), 50-1 USTC 9309.

The rule relied upon by the Collector stems from dicta in a decision of this court, dicta in circuit court opinions and two square holdings in circuit court opinions, all of which cases involved the legality or amount of deductions. It requires the taxpayer to prove, to the last dollar, the amount of refund to which he is entitled, in a District Court suit for refund.

The rationale of this rule seems to be two-fold; first, that where the taxpayer has an option of administrative procedure and a Tax Court trial, or payment of the assessment and suit for refund in District Court, that the taxpayer must be bound by a rigorous old common law rule which did not contemplate suit to recover arbitrarily con-

fiscated property, and second, that the taxpayer should be able to prove his claimed deductions were both legally deductible and factually extant.

In these cases, no administrative procedure was granted, and recourse to the Tax Court was not permitted (infra p. 57). These taxpayers had no option.

In these cases, there was no question as to the legality or amount of any deduction. *This is the first such case in any circuit.* All of the deductions were accepted by the Collector as claimed by the taxpayers.

The question presented here is new. The Collector has arrived at a figure for Gross Receipts which the court below has stated to be false, by a method demonstrated to be wholly erroneous. The Collector is not asking the taxpayers to establish their deductions or expenditures, but is asking that they prove that they did *not* have the Gross Receipts asserted by the Collector's fallacious method, that they prove exactly to the last dollar, how much sales they did *not* have!

The instruction (R. 267) that the taxpayer "must show that every dollar he receives is unjustly withheld from him" was erroneous and prejudicial. Once sales tickets are determined to be incorrect, and disregarded, no direct method of proving sales exists other than by producing every potential and actual customer as a witness. That method is impossible. The taxpayer can support his sales figures only by indirect means, based upon percentages and probabilities; he cannot show "every dollar." At best he can only show that his sales were probably between likely minimum and likely maximum figures, and that probably some approximate percentage of them

were subject to excise tax. Dollar accuracy is completely impossible. The Collector based his assessments upon percentages and (im)probabilities; he should not be permitted to retain the entire amounts of the alleged deficiencies merely because the taxpayers cannot support their sales figures perfectly.

It is not justice to require a taxpayer to carry the burden of proving that his sales were *not* some admittedly erroneous figure arbitrarily set by the Collector by a method false on its face. The Tax Court rule on burden of proof is the proper one to apply in this situation, rather than the rule of the court below. Otherwise the Collector is permitted to seize, without hearings, monies admittedly not due, and hold them because the taxpayer can prove with exactitude only the fact of error and not the precise amount thereof.

B. THE RULING OF THE COURT BELOW REQUIRES THE TAXPAYERS TO PROVE THEIR CASE THROUGH RECORDS AND TESTIMONY IMPOSSIBLE TO OBTAIN, WHICH OTHER MERCHANDISERS SIMILARLY SITUATED DO NOT AND CANNOT OBTAIN.

The court's ruling (infra p. 63) that "appellants completely failed to establish by competent evidence the amount of shrinkage incurred in their businesses. They had no records or factual testimony showing shrinkage losses . . . If a taxpayer's books failed to reflect certain essential facts, he must suffer the consequences . . ." is the most important aspect of the opinion to small businessmen.

What is available as proof in a case such as these? The Collector can show what appeared in the books and records made available by the taxpayer, what appeared

in the taxpayer's tax returns, what appeared in the books and records and tax returns of taxpayers' competitors, what national and regional averages appeared from governmental analyses, and specific unreported sales. The taxpayer can show only what appeared in his books and records and tax returns, including gross profit percentages from other years not contested by the Collector, and his opinions and estimates based upon experience. Competitors' records and government figures are unavailable to him.

The books and records of a small retailer (with a one, two or three man store) cannot be expected to show shrinkages directly. He cannot maintain stock control records and perpetual inventories.

> "Because of the work involved, especially where the product dealt in is small in value and sales are numerous—as in stores dealing in clothing, food, and the like—no record of the cost of each article is kept as it is sold, only the sale price being recorded. It is not possible, therefore, to determine from the records as usually kept, the cost of the goods on hand at a given time. The records are kept in this way, not because systems of accounting cannot be devised to make both records, but because *the results obtained by such systems are not justified by their cost* when other and less expensive means can be used with almost as satisfactory results. . . . The expedient of physical inventory-taking is, therefore, brought in as an aid to the accounting records. It serves both the interests of economy and accuracy, for many inaccuracies result where current record of the cost of goods sold is attempted. Exact accuracy of measurement when goods are brought in large quantities is impossible, nor it is possible in connection with loss from thievery, shoplifting,

shopwear, etc." (*Kester*: *Principles of Accounting* (*4th Ed.*) *p.* 47 - *Need for the Physical Inventory*). ". . . However desirable this information may be, the great difficulty of securing it accurately has caused most merchants to adopt the physical inventory method . . ." (*ibid*: *p.* 93 - *last sentence*).

In the absence of stock control records and a perpetual inventory system, no direct means of listing shrinkages is possible.

No matter how complete a listing may be attempted by a store maintaining stock controls, most thefts, and merchandise unconsciously lost, do not show up until a physical inventory is taken. The difference between the physical inventory and a perptual inventory determines the extent of these losses (*Kester*: *Principles of Accounting* (4th Ed. p. 100 - *Objections to Perpetual Inventory*, p. 101 - *Verification of Perpetual Inventory*) (*Finney & Miller*: *Principles of Accounting - Intermediate* (4th Ed.) p. 399 *second paragraph*), the very existence of which is uncertain until the physical inventory is complete (although they are expected and inevitable in any jewelry business). Stock control records cannot practically be kept closely enough to permit a listing of all the individual items lost or stolen; only the dollar totals are ascertainable. This type of shrinkage loss can *only* be determined by subtracting dollar totals, never by directly listing the individual unknown items.

Shrinkages are not expense deductions; nowhere in the Internal Revenue Code or Regulations it is permitted to deduct shrinkages as Expenses. They are a part of Cost of Goods Sold and must be deducted directly from

Gross Receipts. In *Lang Broom Co.*, 9 BTA 39, the Collector disallowed a shrinkage deduction in the non-operating section of the income statement, on the theory that it should have been included in Cost of Goods Sold. The specific purpose of Congress in authorizing the "lower of cost or market" method (after formerly requiring original cost) was to permit the inclusion of "markdowns" in Cost of Goods Sold without making a separate listing and deduction of them. The Gross Profit calculation set out by Schedule C, Form 1040, automatically allows the shrinkages, including "markdowns" when inventory is taken at the lower of cost or market. No rule of sound accounting or of the Regulations requires any separate listing and totaliing of shrinkages.

In any case, no attempt was made by the Collector to challenge the Inventory valuations and "markdowns." He accepted and relied upon the Inventory figures, and should not now be heard to object to the "markdowns" taken in these cases.

Since "no record of the cost of each article is kept as it is sold, only the sale price being recorded" (*Kester: Principles of Accounting (4th Ed.)*, p. 47 - *Physical Inventory*) in most stores, and only a part of the sales tickets of these taxpayers were marked with the inventory cost, it is impossible to determine total shrinkage by subtraction of the total sale tickets costs from the Cost of Goods Sold. Given the average "mark-up" percentage and the Cost of Goods Sold (both of which are agreed upon here), the *only* method of ascertaining shrinkage is by *first* assuming a correct gross profit percentage or Gross Receipts figure, and then arriving at shrinkage by deduction. It is impossible when the gross profit percentage or Gross Receipts

figure is questioned. Therefore a valid challenge to taxpayers' gross profit percentages and Gross Receipts figures is impossible by using the "mark-up" approach of the Collector's method. *That method admits of no verification or defense, and it is an obvious fallacy.*

To require the small businessman to use an accounting system suitable only for a large business, as was done here by the court's instructions and Collector's theory that shrinkages must be separately stated, deducted and proven, is to put him out of business through excessive overhead costs.

If the court is upheld, every small retailer will be defenseless against such an excise tax assessment as made in these cases.

QUESTION V

The confusion in these cases, the errors below and the great length of this petition, all arise from the fact that the trial court refused the testimony offered by taxpayers on accounting practices and procedures, which refusal prevented the contesting of the erroneous "judicial notice" taken.

A. TESTIMONY IMPROPERLY REJECTED.

In its opinion (infra p. 67), the appellate court says "an examination of his (Comer's) entire testimony shows that the only part of his testimony which was excluded was that wherein he attempted to explain accounting procedure employed by someone else in keeping books, of which he manifestly had no personal knowledge." Among the questions cited in taxpayers' brief below which were asked of Comer and rejected by the trial court are (R. 151):

Q. On cross-examination, Mr. Comer, Mr. Croft indicated that they took four months of your sales tickets for 1945, and figured your mark-up and applied that mark-up to your cost of goods in 1942, 1943, and 1944, to determine your gross profit on your sales. Would that determine your sales for those years, that method?

Mr. Croft: Object to that as calling for a conclusion.

The Court: Yes, objection sustained . . .

Q. And if you had the sales tickets for every month with the sales price accurately put on there for every month of the year, and the accurate costs for every month, or for every sale of every month, on those tickets, and averaged them and deducted the cost from the selling price and called that your mark-up, would that represent your gross profits? . . .

The Court: Well, now, gross profit is the result of a lot of conclusions.

Mr. Jones: They have confused mark-up and gross profits.

The Court: Well, your question confuses me. I don't think the witness can answer that and, if he did, it would be wholly a conclusion of this witness; and, moreover, it is one of the questions this jury is called on to answer.

Mr. Jones: No, it isn't. They have to have some evidence before they can answer it.

The Court: *That is right, but we are not going to have evidence in the form of a witness telling them what it is they are going to decide. Objection sustained. If there is not an objection, I will make one and sustain it.* (R. 151-2).

The questions did not ask for Mr. Comer's conclusion or opinion. They asked only for specific business facts within the knowledge of the witness.

> Q. (By Mr. Jones) Do the sales tickets have any thing to do in your business, the costs on the sales tickets, with determining your gross profits?
>
> The Court: Well, now, isn't it a job for you attorneys and for the Court and jury to decide, on the basis of what those sales tickets say and in accordance with accepted accounting principles, of which we take judicial notice here, whether or not some figures on a sales ticket have anything to do with determining gross profits?
>
> Mr. Jones: Well, of course, I have the accountant to testify to that.
>
> The Court: I am not so sure an accountant can testify to that. That is the very question this Court and jury must decide; whether or not, given certain figures on a sales ticket or in the books and records of account whatever they are, any of the factors influence gross profits. Now, we will decide that. I don't think we need an accountant, and we certainly don't need this witness' testimony . . . (R. 152-3).

The witness was entitled to explain how the costs on his sales tickets affected gross profits, if at all. These were peculiar business facts within his knowledge, and were neither opinions nor conclusions.

> Q. Is your mark-up on your tickets higher than your gross profit percentage? A. Yes, it would always be, as long as you took an inventory loss and figured in all your other losses that came in your merchandise.
>
> The Court: Well, we are surely talking about

a hypothetical thing here. I don't know which ticket you are talking about . . .

Mr. Jones: I don't think your Honor gets my point at all.

The Court: Well, you are talking about sales tickets.

Mr. Jones: They have no relationship whatever to the gross profits.

The Court: I understand, that is what you think . . .

Mind your record, Mr. Croft. These questions call for conclusions, it appears to me, the very conclusion we are going to ask this jury to draw; some of them are conclusions the Court is going to draw. (R. 154-6).

Q. And those (shrinkages) were all reflected in your inventory? A. Yes. . . .

Q. (By Mr. Jones) And that (end of the year) inventory does all of the adjusting for these losses; is that right? A. Yes . . .

The Court: We have gone all over that above seventeen times. I am not going to allow you to repeat any more of this evidence during the entire balance of the course of this trial. It is perfectly obvious that this has been repeated at least twenty times. . . .

Q. So, putting the mark-up from the sales tickets to your cost of goods sold at the end of the year would do what?

The Court: That is a conclusion of this witness, and we don't need this witness' testimony on the subject. This is an accounting problem. I take judicial notice of accounting practices. As a matter

of fact, you can tell the jury what it will do. Tell them.

The record shows that only Comer dealt with the sales tickets and the cost marks thereon, and that he reported to Wayne Decker only the sales, not the cost marks on their totals, and hence was the *only* person who could answer the questions from personal knowledge.

The objections made and sustained were that the questions called for "opinions" and "conclusions." These questions called for the results of mathematical computations which are simply business facts, not "opinions" or "conclusions" in the sense that they are non-factual or open to argument. The questions may be compared in principle to this question asked of an actuary: "Given a sum of $10,000 invested today at 5% per annum, what must be the amount of each of 12 equal monthly payments commencing one month from date, in order that the entire $10,000 plus all interest be paid out by the 12th payment?" The actuary may state the answer, which is not an "opinion" or "conclusion" but a mathematical fact. It is not a fact which may be readily determined by the average court or jury or attorney, but which requires expert knowledge to determine. Similarly here, the questions called for specific business facts which the trial court itself acknowledged (R. 160) were "mathematical computations", but nevertheless ruled to be mere "opinions" and inadmissible.

These questions were designed to show the error in the Collector's method, and if pursued, would have led to a demonstration of the magnitude of that error, through mathematically necessary reasoning.

The appellate court below says (infra p. 68) "Neither did the court prevent taxpayers' accountant, Pinnock, from

testifying with respect to data reflected in their books. He was only restricted in his testimony when he undertook to draw conclusions from facts not in the record."

The record shows (R. 164-7) that questions similar to the actuarial one above were characterized by the trial court as "hypothetical" and "not proper subjects of expert testimony." Technical accounting matters need just as much expert accounting explanation to court and jury as X-rays of the human body need expert medical explanation, which explanation in either case is factual, not "hypothetical," and is clearly a "subject of expert testimony." Pinnock was attempting to state mathematically necessary conclusions, not "conclusions" in the sense used by the court below as contestable opinion.

Had Pinnock been permitted to explain even the schedules admitted, not only would the Collector's error have been apparent, but its very great magnitude would have been obvious. From records kept by Certified Public Accountants which were uncontested by the Collector, Pinnock could have conclusively demonstrated shrinkages sufficient to account for all the differences between "mark-up" and gross profits. Without his expert explanation of these exhibits (R. 289 - 297), they were as useful as an unexplained barium X-ray to an elementary school hygiene student. This material was factual, non-self serving, and not speculative, but was rejected by the trial court.

B. "JUDICIAL NOTICE" IMPROPERLY TAKEN BY MEANS OF AN ACCOUNTING INSTRUCTION TO THE JURY.

If the material rejected as "opinion" and "conclusion" was in fact merely that, then the trial court's "judicial notice" was likewise mere opinion. This seems to be the ap-

pellate court's belief, as it states (infra p. 68) ". . . did not preclude taxpayers from disputing the court's *opinion*." But judicial notice is not opinion, it is judicial recognition of a *fact;* anything recognized as mere opinion may not be the subject of judicial notice. The arbitrary substitution by "judicial notice" of the trial court's erroneous opinion for the offered testimony, deprived the taxpayers of a hearing on the essential point of their case, and was a denial of due process.

This "judicial notice" was taken by means of accounting instructions to the jury (R. 276-7). The appellate court below says (infra p. 68): "Analyzing each instruction and setting out the evidence applicable thereto would only unduly intend this opinion . . ." and completely avoids discussion of the vital argument in taxpayers' brief. Taxpayers' brief carefully analyzed the accounting instructions and supported the analysis completely by standard accounting texts. Neither the analysis nor the authorities were directly challenged by the Collector, or referred to by the opinion below. This analysis showed that if shrinkage existed, as the appellate court acknowledged, there were eight major accounting errors in the instructions which had the cumulative effect of a directed verdict. No "setting out the evidence applicable" was required. The instructions are bad by mathematical necessity. The courts below, in making and approving such instructions show themselves to be totally incompetent as accountants, either incapable or unwilling to follow accounting analysis, and not sufficiently honest to recognize their limitations; instead the trial court has taken "judicial notice" of an untruth, denied the taxpayers the right to contest his ruling, and the appellate court has affirmed him while at the same time

taking judicial notice of the fact that completely destroys the accounting instructions.

Further, the instructions authorized the jury to find fraud if the mathematically impossible requirements of the instruction are not met, thus directing a fraud verdict against which the taxpayer is not permitted a defense, and on which the Collector is not required to prove anything.

All this because the trial court arrogantly denied the taxpayers the right to testify as to their own particular accounting practices and their accountant the right to explain accounting facts and procedures, and substituted therefore his own erroneous opinion of what constituted "proper accounting procedures" in these cases.

Had the courts below followed the decision of this court and permitted a contest of the "judicial notice," the Collector's error, its great magnitude and wide importance, would be manifest in the record. Their failure to do so has resulted in a denial of due process.

C. THE RULING BELOW DENIES PETITIONERS DUE PROCESS, BY IN FACT DENYING THEM THE RIGHT TO CONTEST "JUDICIAL NOTICE" TAKEN, IN CONFLICT WITH A DECISION OF THIS COURT.

The applicable opinion of this court is *Ohio Bell Telegraph Co. v. Public Utilities Commission*, 301 U.S. 297, 57 S. Ct. 724, 81 L. Ed. 1093 (a party may always contest "judicial notice" taken, by the introduction of competent contrary evidence; denial of this right infringes due process). Although paying lip service to this rule, the court below has denied petitioners herein the right to contest this vital error.

If Comer was not legally competent to testify as to his own personal accounting practices, who was? If Pinnock, Certified Public Accountant, was not competent to explain accounting theory, practice and procedures, who was? If an accountant may not, in testifying, define and explain the terms he uses, then why is testimony involving obscure technical terms ever admissible? If the result of a mathematical computation is a contestable, inadmissible "conclusion", merely an "opinion", then what *is* certain fact in this life?

The refusal of this testimony was a denial of due process of law.

SUMMARY OF REASONS FOR GRANTING A WRIT

The required administrative procedure was not granted these petitioners; fraud was not pleaded in compliance with Rule 9 (b), FRCP; fraud was not proved within the particulars pleaded; an improper and impossible burden of proof was placed upon petitioners; and petitioners were not permitted to contest "judicial notice" erroneously taken.

The Collector would not talk with petitioners prior to assessment or at all; he would not plead his fraud properly; he would not prove the insufficient allegations of fraud which were pleaded; and the trial court would not permit petitioners to prove their case.

Reversal of this denial of due process is of the first importance to every citizen. The importance to small businesses of being required to prove shrinkage losses by shrinkage records is too great to permit the requirements established by the circuit court to stand. The conflicts in

fact and principle among the court decisions, and the total disregard for established statutory substantive and procedural law call for the issuance of a writ of certiorari.

CONCLUSION

It is respectfully requested that this petition for a writ of certiorari to the Circuit Court of Appeals for the Tenth Circuit be granted.

Respectfully submitted,

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APPENDIX A

STATUTES INVOLVED

AMENDMENT V. DUE PROCESS OF LAW.

* * * nor be deprived of life, liberty, or property, without due process of law; * * *

5USC 1002. PUBLICATION OF INFORMATION, RULES, OPINIONS, ORDERS AND PUBLIC RECORDS.

Except to the extent that there is involved (1) any function of the United States requiring secrecy in the public interest or (2) any matter relating solely to the internal management of an agency—

(a) Every agency shall separately state and currently publish in the Federal Register (1) descriptions of its central and field organization including delegations by the agency of final authority and the established places at which, and methods whereby, the public may secure information or make submittals or requests; (2) statements of the general course and method by which its functions are channeled and determined, including the nature and requirements of all formal or informal procedures available as well as forms and instructions as to the scope and contents of all papers, reports, or examinations; and (3) substantive rules adopted as authorized by law and statements of general policy or interpretations formulated and adopted by the agency for the guidance of the public, but not rules addressed to and served upon named persons in accordance with law. No person shall in any manner be required to resort to organization or procedure not so published.

(b) Every agency shall publish or, in accordance with

published rule, make available to public inspection all final opinions or orders in the adjudication of cases (except those required for good cause to be held confidential and not cited as precedents) and all rules.

(c) Save as otherwise required by statute, matters of official record shall in accordance with published rule be made available to persons properly and directly concerned except information held confidential for good cause found. June 11, 1946, c. 324, Sec. 3, 60 Stat. 238.

5USC 1011. IMPAIRMENT OF RIGHTS; EFFECT ON OTHER LAWS; SEPARABILITY; SUBSEQUENT LEGISLATION; EFFECTIVE DATE.

Nothing in this chapter shall be held to diminish the constitutional rights of any person or to limit or repeal additional requirements imposed by statute or otherwise recognized by law. Except as otherwise required by law, all requirements or privileges relating to evidence or procedure shall apply equally to agencies and persons. If any provision of this chapter or the application thereof is held invalid, the remainder of this chapter or other applications of such provision shall not be affected. Every agency is granted all authority necessary to comply with the requirements of this chapter through the issuance of rules or otherwise. No subsequent legislation shall be held to supersede or modify the provisions of this chapter except to the extent that such legislation shall do so expressly. This chapter shall take effect three months after its approval except that sections 1006 and 1007 of this title shall take effect six months after such approval, the requirement of the selection of examiners pursuant to section 1010 of this title shall not become effective until one year after such approval, and

no procedural requirement shall be mandatory as to any agency proceeding initiated prior to the effective date of such requirement. June 11, 1946, c. 324, Sec. 12, Stat. 244.

26USC 275 (a) (1939-53 Code) PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in section 276—

(a) *General Rule.* The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

26USC 874 (a) (1939-53 Code) PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

(a) *General rule.* Except as provided in subsection (b) the amount of estate taxes imposed by this subchapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of three years after the return was filed.

26USC 1016 (a) (1939-53 Code) PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

(a) *General rule.* Except as provided in subsection (b), the amount of taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of three years after the return was filed.

26USC 1635 (a) (1939-53 Code) PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION OF CERTAIN EMPLOYMENT TAXES.

(a) *General rule.* The amount of any tax imposed by subchapter A of this chapter or subchapter D of this chapter shall (except as otherwise provided in the following subsections of this section) be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

26USC 3312 (a) (1939-53 Code) PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except in the case of income, estate, and gift taxes—

(a) *General rule.* All internal revenue taxes shall (except as provided in subsections (b), (c), and (d) be assessed within four years after such taxes become due, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of five years after such taxes shall become due.

26USC 6501 (a) (1954 Code) LIMITATIONS ON ASSESMENT AND COLLECTION.

(a) *General rule.* Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, within 3 years after such tax became due, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

26USC 276 (a) (1939-53 Code) SAME—EXCEPTIONS.

(a) *False return or no return.* In the case of a false or fraudulent return with intent to evade tax or of a failure to file a return the tax may be assessed, or a proceed-

ing in court for the collection of such tax may be begun without assessment, at any time.

26USC 874 (b) (1) (1939-53 Code)

(b) *Exceptions.*

(1) *False return or no return.* In the case of a false or fraudulent return with intent to evade tax or of a failure to file a return the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

26USC 1016 (b) (1) (1939-53 Code)

(b) *Exceptions.*

(1) *False return or no return.* In the case of a false or fraudulent return with intent to evade tax or of a failure to file a return the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

26USC 1635 (b) (1951-53 Code) PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION OF CERTAIN EMPLOYMENT TAXES.

(b) *False return or no return.* In the case of a false or fraudulent return with intent to evade tax or of a failure to file a return the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

26USC 3312 (b) (1939-53 Code)

(b) *False return or no return.* In the case of a false or fraudulent return with intent to evade tax, or of a failure to file a return the tax may be assessed, or a proceed-

ing in court for the collection of such tax may be begun without assessment, at any time.

26USC 6501 (c) (1) (1954 Code)

(c) *Exceptions.*

(1) *False return.* In the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.

28USC FRCP 9 (b)

(9) Pleading Special Matters.

(b) *Fraud, Mistake, Condition of the Mind.* In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.

28USC FRCP 15 (b)

(15) Amended and Supplemental Pleadings.

(b) *Amendments to Conform to the Evidence.* When issues not raised by the pleadings are tried by express or implied consent of the parties, they shall be treated in all respects as if they had been raised in the pleadings. Such amendment of the pleadings as may be necessary to cause them to conform to the evidence and to raise these issues may be made upon motion of any party at any time, even after judgment; but failure so to amend does not affect the result of the trail of these issues. If evidence is objected to at the trial on the ground that it is not within the issues made by the pleadings, the court may allow the pleadings to be amended and shall do so freely when the

presentation of the merits of the action will be subserved thereby and the objecting party fails to satisfy the court that the admission of such evidence would prejudice him in maintaining his action or defense upon the merits. The court may grant a continuance to enable the objecting party to meet such evidence.

FEDERAL REGISTER, Wednesday, September 11, 1946, Volume 11, No. 179 A-49, Section 601.6 (formerly 26 CFR 601.6, part 29; now 26 CFR 601.48-9):

(c) *Proposed assessments of additional or delinquent taxes.*—

(The first paragraph of the section merely states that proposed assessments may arise in two ways: a Washington audit or as a result of a field examination.)

(The second paragraph of the section sets forth the procedure which must be followed in the event the assessment results from a Washington audit. Assessments resulting from field examinations is set forth in the following paragraph.)

"When the occasion for the proposed assessment of additional or delinquent tax arises as the result of an examination of the taxpayer's books and records conducted by an Internal Revenue Agent assigned to the Miscellaneous Tax Field Force or by a deputy Collector of Internal Revenue, the Taxpayer is furnished with a copy of the investigator's report (except in situations of a confidential nature such as a case involving fraud) "and is given an opportunity to confer with the investigator and, if desired, with the Internal Revenue Agent in charge of the Miscellaneous Tax Field Force for that area, in the case of an investigation conducted by an agent attached to that

force, or with the Chief Field Deputy attached to the office of the Collector of Internal Revenue for the taxpayer's district, in a case where the investigation was conducted by a deputy collector . . .

(The balance of this paragraph refers to situations where the taxpayer agrees to the deficiency.)

In cases where no agreement can be reached in the field as to the amount and payment of any additional or delinquent tax disclosed by the investigation, the original of the investigating officer's report, as approved by the Internal Revenue Agent in charge or the Collector of Internal Revenue, as the case may be, together with any protest or submission the taxpayer may have made while the case was in the field, is forwarded to the Washington office of the Miscellaneous Tax Unit (See Para. 600.7). A copy of such report is also given to the taxpayer. If, after review of the report in Washington, it is considered that no additional or delinquent tax is due, the investigating officer is so notified and no further action on the part of the taxpayer is necessary. If, however, it is concluded that assessment of the tax is in order, the taxpayer is advised that he is privileged to submit a protest or request a conference in regard to the proposed assessment within a period of fifteen days or such other longer period as may be appropriate under the circumstances. If, after consideration has been given to the taxpayer's contentions as to why the tax should not be assessed, it is concluded that no assessment should be made, the investigating officer is so notified and the case is then closed without further action. If, however, no protest or request for a conference is received from the taxpayer within the stated period or, if after consideration has been given to any

protest submitted, it is concluded that assessment of the additional or delinquent tax is in order, the amount of tax (together with any applicable penalties "and interest) is entered on an assessment list for collection in the usual manner. See S. T. 915, Internal Revenue Bulletin, 1941-1, page 455.

Conferences regarding proposed assessments of additional or delinquent taxes are subject to the same general rules as are conferences on rulings, as described in paragraph (b) of this section.

(d) Administrative remedies available to taxpayers after assessment and/or payment of sales taxes alleged to have been erroneously or illegally assessed or collected.

(1) Before payment has been made.

(The provision in this first paragraph permits a claim for abatement on Form 843).

In the case of a claim for abatement, the Collector may require the taxpayer to furnish bond in double the amount of the tax involved so that the interests of the Government will be protected while the claim is pending.

(2) After payment has been made.

(The provision in this first paragraph permits claim for refund or credit on Form 843).

If the claim for refund is rejected, the taxpayer is notified of the rejection by registered mail and, in such a case, the taxpayer may bring suit for recovery of the tax in the appropriate court within two years from the date of the rejection notice. See 601.1 (d). The Tax Court has no jurisdiction over sales tax cases and, consequently, this form is not available for the adjudication of disputes as to sales tax liability. See 601.1 (d)."

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APPENDIX B

CIRCUIT COURT OPINION

GLENN E. FULLER (Jack R. Decker, Shirley P. Jones and Shirley P. Jones, Jr., were with him on the brief) for Appellants;

vs.

ALONZO W. WATSON, JR., Special Assistant to the Attorney General, (H. Brian Holland, Ass't. General, Ellis H. Black and Les A. Jackson, Special Assistants to the Attorney General, and A. Pratt Kesler, United States Attorney, were with him on the brief) for Appellee.

Before PHILLIPS' Chief Judge, HUXMAN and PICKETT, United States Circuit Judges

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HUXMAN, Circuit Judge

The appeals in these five cases involve the assessment of excise tax deficiencies and fraud penalties for the years 1942, 1943 and 1944 against appellants who were engaged in jewelry businesses. The cases were consolidated for trial in the court below and are presented here on a consolidated record. The issues and questions in the last four cases are identical and they will be considered together. Case Number 4754 presents a different question and it will be separately considered.

Cases Number 4755, 4756 ,4757, and 4758

The general statements in these four cases with respect to the manner in which the businesses were being conducted, books and records kept, and other general operations have equal application to case Number 4754. Wayne Decker, one of the appellants in Number 4754, plays the leading role in all five cases. He was in the jewelry business in Salt Lake City, Utah, and largely financed the jewelry businesses operated by the other appellants. The Mullett Jewelry Company and the Mitchell Jewelry Company were both located in Provo, Utah. Another Mullett Jewelry Store was located in Cedar City, Utah. A fourth store, the Jewel Box, was located in Logan, Utah, and a fifth store, the Dixie Jewel Shop, was located in St. George, Utah. Frank J. Mullett was a partner in the Mullett Jewelry Store and the Mitchell Jewelry Store in Provo and operated the Mullett Jewelry Store. The Mitchell Jewelry Store was managed by W. E. Mitchell. Wesley F. Mullett operated the Mullett Jewelry Store in Cedar City. Harold Comer operated the Jewel Box at Logan, Utah. Lee Weibel operated the Jewelry Store in St. George. Ernest B. Eldredge was a partner with Wayne Decker in the Jewelry Store in Salt Lake City, involved in case Number 4754. The books and records for all the stores were kept by Decker in Salt Lake City and he also prepared most of the excise tax returns filed by the appellants for the businesses for the tax years in question.

In the spring of 1945, the Collector of Internal Revenue for the District of Utah began investigation of appellants' businesses. The investigation was carried on largely by Special Agent, Daniel M. Smith. During the course of his investigation he attempted to gain as much information

as possible from appellants concerning the total amount of their sales for the years in question, in order to determine whether the amount they reported for excise tax purposes was correct. He contacted and discussed with them their buiness operations and their relationship with Decker. He secured from them whatever sales tickets, purchase agreements, check stubs, or other accounting data they had. He examined and analyzed this accounting data and discussed with the taxpayers questions concerning the proper interpretation of the information. He also obtained and inspected bank ledger cards carried in the names of certain taxpayers. The information shown on these ledger cards was discussed with the taxpayers in order that the relationship between the business earnings and deposits and between certain withdrawals might be properly understood and interpreted.

Sworn statements were secured from all appellants as part of the investigation. The first of such statements was given by Decker on June 1, 1945. This statement related to the operation of the Mullett and Mitchell Jewelry Stores in Provo, Utah. In the two statements concerning these stores, Decker denied that the businesses were being operated as partnerships. On the next day he sought out the revenue agents and told them that he wanted to change his story. On his request, an additional sworn statement was taken from him in which he stated not only the Mullett and Mitchell Stores but also the Dixie Jewel Shop, the Mullett Jewelry Company in Cedar City, and the Jewel Box were operated as partnerships. He stated the partnerships were formed some time in 1942 or 1943 and that under the arrangement the profits from the businesses were split equally after the managing partner's monthly

drawings were deducted. All the managing partners in their respective sworn statements acknowledged the partnership arrangement with Decker and further stated that Decker prepared their income tax returns on which they were represented as sole proprietors of the business, when in fact they knew they were not such sole proprietors.

As a result of the investigation, notices and demands for additional excise taxes, penalties and interest were mailed to Decker on February 12, 1948. Copies of these notices and demands were not mailed to the other taxpayers. The notices and demands set forth separately the additional tax claimed due, the penalty and interest thereon, and the total amount claimed to be due. After a request by Decker's representative to extend the time, nothing further was done until July 13, 1948, when the same forms except for date were sent to Decker. Shortly thereafter he filed an action in the Utah Federal District Court seeking to enjoin the collections of the taxes, interest and penalties covered by the notices and demands of February 12, and July 13, on the ground that he was not a partner and did not owe the taxes. A temporary restraining order was entered with the suggestion that the Government attempt to collect the taxes from the other taxpayers.

Thereafter, on December 9, 1946, notices and demands for the taxes and penalties were sent to the other four taxpayers who paid them from funds furnished by Decker. The injunction proceeding in the District Court was thereafter dismissed. Claims for refunds were filed by appellants with the Commissioner of Internal Revenue and, such claims not having been honored, in due course these actions were filed to recover the amounts so paid.

Each of the five complaints alleged that the excise taxes and fraud penalties were illegally and erroneously assessed and collected; that improper notices and demands for the taxes and penalties had been made; that inadequate information concerning taxes allocable to particular tax periods had been furnished; that the assessment and collection of the taxes, penalties and interest were illegal and void for the reason that the statute of limitations had run; that the notices and demands were not made as required by Section 3312 of the Internal Revenue Code of 1939; that the procedure followed was void because the procedure prescribed by the Administrative Procedure Act had not been followed and that there was no authority for the collection of the penalties.

The Collector entered a general denial of all these allegations and affirmatively asserted the defense of fraud for the tax years involved, alleging that no monthly partnership returns were filed as required by law, reporting the taxes due upon the sales of jewelry; that returns for certain months were not verified as required by law; that taxpayers, wilfully and knowingly attempted to defeat and evade a large part of the taxes due by failing to file certain returns and by filing false and fraudulent returns; that taxpayers knowingly reported their taxable sales as being considerably less than actual sales; that the true picture of taxable sales was distorted because substantial costs of sales were shown on taxpayers' books as costs of repairs and that Decker knowingly and wilfully failed to keep proper and adequate books for the partnership businesses.

Taxpayers moved for directed verdicts in regard to the fraud penalties for the year 1944 because fraud had not

been pleaded with particularity. Similar motions were made for the years 1942 and 1943. These motions were denied. Upon trial by a jury, a general verdict was rendered against taxpayers. Judgments were entered thereon and these appeals followed.

While a number of issues are presented by these appeals, the main issue centers around appellants' contention that the Collector failed to make a case for the assessment of fraud penalties. Appellants center their attack upon the method employed by the Collector to establish sales other than those reported by appellants. They strenuously argue that in reconstructing appellants' total sales the Collector made no allowance for depreciation or loss resulting from merchandise which was either broken, lost, depreciated in value, or which had lost all value.

We start with the fact that appellants kept only fragmentary records. They kept no complete set of books, no beginning or closing inventories. They kept no depreciation account or record of merchandise lost, stolen, depreciated in value, or having lost all value. The Collector was hard put to reconstruct appellants' financial structure from the fragmentary records available to him in order to determine gross sales.

Decker made out all the excise tax returns for the various stores except one. He also made out all the taxpayers' income tax returns for the years in question. He kept the books for all the stores at his place of business in Salt Lake City, Utah. Taxpayers sent in information either once or twice a month. This information generally consisted of summaries of sales, amount of cash received from either sales or collections, paid-outs and occasionally

cancelled checks and break-downs on excise and sales taxes. Decker stated that his books accurately and completely represented the information sent to him. The records for the W. E. Mitchell Jewelry Company and the F. J. Mullett Jewelry Company of Provo, Utah, for the year 1942 were missing. The records kept by Decker consisted only of ledger accounts and contained only monthly entries and annual totals for each store. He did not retain the data sent to him each month from which the information was taken that was entered in the ledger.

The information sent to Decker by the other appellants was destroyed by him and with one exception the other appellants did not make or retain copies of any monthly reports sent to Decker and in that one exception the summarized list sent to Decker did not contain all the sales. Complete sales tickets for one full year were available from only one store, the Dixie Jewel Shop, for 1943. The sales shown on these tickets were considerably in excess of the sales shown on Decker's books. The evidence further shows that in many instances merchandise sales were shown as repairs, not subject to excise taxes. Sales shown for years after the investigation began were considerably in excess of those for the years in question. Bank deposits made solely from business profits showed that the business had larger profits than what was shown on Decker's books. The inventories reported for the years following the investigation were many times greater than for the years in question.

Faced with these facts and with wholly incomplete and fragmentary records, the Collector was faced with the necessity of reconstructing the picture of total sales as best he could. The method employed by the Collector was as fol-

lows. He took the cost of goods sold as reflected by the books of appellants and applied thereto a mark-up percentage which was obtained from an examination of the sales tickets available to him. Each sale ticket had written on it a code number which represented the cost to the dealer at that time. By dividing the difference between the cost of that item and the total selling price by the cost of the item, the Collector obtained what is called a mark-up percentage. Since he did not have nearly all the sales tickets for the years in question and since the evidence showed that the gross sales reported by appellants for excise tax purposes were much less than actual gross sales, the Collector applied the mark-up percentage to the cost of goods sold as reported by appellants to obtain a sales figure more nearly in line with actual sales. Collector Smith did compute and make some allowance for repairs. Otherwise he made no allowance for shrinkage losses.

It is obvious that this method was erroneous to the extent that it did not allow something for shrinkage. Shrinkage includes freight and handling cost. It also includes items of merchandise which have been stolen, used in advertising, or which have become broken or lost. It also includes values which have been eliminated from the inventory by "mark-downs." We think we may take judicial knowledge that shrinkage does occur in all merchandising business.

While it may be conceded that there was a margin of error in the Collector's method, it does not follow that a reversal must follow therefrom. Those were suits to recover money paid under protest. In such an action the taxpayer must not only show that the Commissioner was

wrong but he must further show the amount he is entitled to recover. In other words, he must establish the facts from which a correct determination of his tax liability can be made.[1] This principle is well stated in *Taylor v. Commissioner*, 70 F. (2d) 619, 621, as follows:

> "But the reason for this is obvious; a plaintiff, seeking an affirmative judgment measured in dollars, must prove how much is due. His claim is for money paid and he must show that every dollar he recover is unjustly withheld. So it is not enough merely to prove that the tax as a whole was unlawful; some of the dollars he paid may nevertheless have been due."

Appellants completely failed to establish by competent evidence the amount of shrinkage incurred in these businesses. They had no records or factual testimony showing shrinkage losses for the years in question. Their statement that shrinkage amounted to 20% was not based upon facts. It was not taken from sales or any records which they kept. It merely constituted their opinion and conclusions as to what the percentage of shrinkage should be. Such statements and self-serving declarations. If a taxpayers' books reflect certain essential facts, he must suffer the consequences.[2]

That appellants greatly understated their total sales in their income tax returns is obvious from the record.

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[1] *Reinecke v. Spalding*, 280 U.S. 227;
Harvey v. Sarly, 189 F. (2d) 169;
Maroosis v. Smyth, 187 F. (2d) 228;
Lewis v. Reynolds, 48 F. (2d) 515; Affirmed 284 U.S. 281,

[2] *Bergdoll v. Pollock*, 95 U.S. 337;
Maroosis v. Smyth, 187 P. (2d) 228.

Thus Frank J. Mullett could not explain why the combined inventories for the Mullett Jewelry Company and the Mitchell Jewelry Company at Provo in his 1944 tax return was approximately $5,000, when the tax return for the year 1945, after the investigation was under way, showed an inventory for the two stores of over $31,000. Decker's books showed cost of repair for the last six months of 1944 to be $8,813, while his check stubs showed the repairs to be only $2,719. W. E. Mitchell, who operated the jewelry company store at Provo, testified that he made a report of every sale and that he had sent Decker a report showing the amount of sales, the cost of sales, accounts receivable, and cost of repairs. He could not explain why Decker's books showed his cost of merchandise for the last six months of 1944 to be $8,929, when his check stubs for the same period showed mechandise purchases totalling $17,650. The witness could not recall whether his inventory was $1,560 at the end of 1942 and $2,357 at the end of 1943, as shown on his tax returns for those years. After reviewing his sworn testimony taken at the time of the investigation, the witness remembered that he had then stated that his inventory in each of those years was about $5,000 or $6,000. He could not explain why his inventory, as shown on his 1944 tax returns, was $2,316 at the end of that year and on the 1945 partnership return it was shown as $17,000.

The taxpayers urge that the court erred in excluding certain evidence relating to accounting practices and, in lieu thereof, instructing the jury that it was taking judicial notice of proper accounting principles. They assert that taxpayer Comer's testimony was excluded to their prjudice. An examination of his entire testimony shows that the only part of his testimony which was excluded was that wherein

he attempted to explain accounting procedure employed by someone else in keeping books, of which he manifestly had no personal knowledge. Neither did the court prevent taxpayer's accountant, Pinnock, from testifying with respect to data reflected in their books. He was only restricted in his testimony when he undertook to draw conclusions from facts not in the record. The court's statement that it would take judicial notice of accounting procedure did not preclude taxpayers from disputing the court's opinion with respect to such procedure by offering competent evidence. The difficulty with appellants' testimony along this line was that it referred to non-factual self-serving conclusions based entirely upon speculation.

Appellants complaint of the court's instructions to the jury and under this assignment list twelve instructions which they claim were erroneous. There is much in appellee's contention that appellants' objections to these instructions were too general and too vague to call the court's attentions to the alleged errors in compiance with Rule 51 of the Rules of Civil Procedure, and that the errors now urged with respect to the court's instructions were not errors assigned in their objections thereto in the trial court. Nevertheless, we have examined the court's instructions in light of the record and are of the conclusion that they correctly framed the issues on the evidence presented in the trial. Analyzing each instruction and setting out the evidence applicable thereto would only unduly extend this opinion which of necessity must be long. Instructions must be predicated on the evidence. They may not deal with general or abstract propositions not immediately connected with and applicable to the facts before the jury. We think the court's instructions met this test. Furthermore,

one may not assign a theory which is unsupported by evidence.[3] The difficulty with appellants' theory as to shrinkage and their request for instructions thereon is there was no evidence to support it. Their whole case with respect to shrinkage was predicated upon a theory and pure speculation.

It is contended that the Collector's answers and amendments thereto did not properly plead fraud and that, therefore, the court erred in refusing to strike the amended answers. The Collector admitted that he did not plead in his answer or the amendments thereto any additional facts of fraud for the year 1944. However, an analysis of the answer and the amendments thereto show that they fully set out facts relied upon to establish fraud for the years 1942 and 1943. Appellants were not unduly surprised and suffered no prejudice for the year 1944, since the Collector's amended answers alleged certain of the facts upon which he relied in assessing the fraud penalties for the year 1944, and taxpayer's had been supplied with certain of the data upon which fraud penalties for that year had been predicated. So also the evidence upon which the Collector relied to establish fraud was introduced in evidence and the trial court ruled that the pleadings could be amended to conform to the proof, pursuant to Rule 15 (b), Federal Rules of Civil Procedure. Failure to formally amend the pleadings will not jeopardize a verdict or judgment based upon competent evidence. If an amendment to the pleadings to conform to the proof should have been made,

[3] *Mitchell v. Potomac Ins. Co.*, 183 U.S. 42;
Rhett v. Poe, 43 U.S. 456, 2 Howard 456;
Indianapolis, etc. R. R. Co. v. Horst, 93 U.S. 291;
McCarthy v. Pennsylvania R. Co., 156 F. (2d) 877;
Loow's Inc., v. Cole, 185 P. (2d) 641.

the Courts of Appeals will presume that it is so made to support the judgment.[4]

It is further contended that the additional excise tax assessments are void because in making them the Collector failed to comply with the procedure published in the Federal Register in compliance with the Administrative Procedure Act. The Administrative Procedure Act, 5 U.S.C.A. §1002 requires that every agency shall publish in the Federal Register the "nature and requirements of all formal or informal procedures" and "substantive rules * * * and statements of general policy or interpretations formulated * * * for the guidance of the public." The Bureau of Internal Revenue published its procedure relative to excise taxes in the Federal Register September 11, 1946, Vol. II, No. 179 A-49, §601.6, prescribing the issuance of a 15 day preliminary letter to the taxpayer allowing him an opportunity to submit a protest or to request a conference. This procedure was not complied with. The Collector, however, proceeded in reliance on Section 3312 (b) of the Internal Revenue Code of 1939, 26 U.S.C.A. §3312 (b), which provides that

> "In case of a false or fraudulent return with intent to evade tax, or of a failure to file a return within the time required by law, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time."

The Commissioner alleged and relied upon the fact that these returns and failure to make returns were fraudu-

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[4] *Ruud v. American Packing & Provision Co.*, 177 F. (2d) 538; *Hansen v. Creedon*, 163 F. (2d) 223; *Underwriters Salvage Co. v. Davis & Shaw Furniture Co.*, 198 F. (2d) 450.

lent. If under Section 3312 (b) he could bring a proceeding in court without even making an assessment at any time, or if he could assess a tax without notice, it follows that the requirement for a fifteen day letter to the taxpayer had no application. It has also been held that an irregularity as to the procedure or time of making an assessment of a deficiency tax will not render the assessment void.[8]

Appellants assert error with respect to the court's instruction as to the statute of limitations. Their position is somewhat difficult to understand. They state whether the statute of limitations has run is a matter of law and that the court erred in submitting the matter to the jury and instructing it with respect thereto. We have read the court's instruction and think it was not only proper but necessary. Obviously, the four year statute of limitations had run with regard to the assessment of 1942 and 1943. unless there was a fraud, which tolled the running of the statute of limitations. Whether there was such fraud was a question of fact for the jury's determination. The court properly instructed the jury that the statute of limitations would be a bar unless it found that there was fraud, in which event, the statute of limitations had no application.

There is no merit whatever to taxpayers' contention that the dismissal of the injunction suit, Civil No. 1498, brought by Decker to enjoin the collection from him of the assessments for the taxes and penalties therein alleged to be due from these taxpayers, is res judicata, and hence determinative of that issue in the instant case. That suit was instituted by Decker on the theory that he was not

[8] *Thomaston Cotton Mills v. Rose*, 62 F. (2d) 982;
Lehigh Portland Cement Co. v. United States, 30 F. Supp. 217.

a partner in those enterprises and, therefore, there was no tax due from him. Upon that allegation, the court entered a temporary restraining order and suggested that the Government proceed to seek a collection of the tax from the remaining appellants. Apparently when it was established by the affidavits of Decker and the remaining appellants that he was a partner with them, that suit was dismissed upon a stipulation filed by the parties because the issue raised was moot. The issue to which the reference was had was that Decker was not a partner. That case in nowise undertook to determine tax liability on the part of Decker or any of the other appellants and, therefore, cannot be res judicata of the issues raised in this proceeding.

In a supplement to their brief, appellants contend that in case number 4758 the Collector for the year 1943 used a completely different method of assessment. This assertion is predicated upon a disputed issue of fact as to the sales slips which were used and considered by Smith in making his computation. Without belabouring the question, it is sufficient to say that the contention is without substantial merit.

(Material relating to the decision in case number 4754, which not being the subject of this petition, has been deleted.)

We have tried to give careful consideration to the complicated record. It is our considered judgment that there is no reversible error. The several judgments appealed from . . . are severally AFFIRMED.

APPENDIX C

AFFIDAVIT

State of Utah
County of Salt Lake ss.

JACK R. DECKER, being first duly sworn on oath, says:

1. That he has personally investigated the matters referred to in this Affidavit, and has talked with counsel involved; and therefore makes this Affidavit as a true and correct statement of his information and belief.

2. That the amusement tax (Miscellaneous Excise Tax) case of Vasco Call, of Brigham City, Utah, involved alleged fraud penalties for the years 1941 through 1945, and were investigated by the same agent who investigated the cases discussed in the petition to which this Affidavit is attached.

3. That although the investigations were made during the same period of time, the procedures followed in the Call case were not followed in petitioners' cases, and the fact that different procedures were followed in that case was concealed from petitioners by the Collector's agents.

4. That administrative hearings at two levels were had in the Call case before it was finally placed in the hands of the Appellate Division in Salt Lake City, where it was settled.

5. That a formal letter advising the taxpayer of a proposed excise tax deficiency, and giving him opportunity to present a written protest and request a conference be-

fore assessment, was received by the taxpayer in the Ca
case.

6. That agents of the Commissioner will not giv
official confirmation or denial of this information.

Dated June 12th, 1955.

Jack K. Decker

Subscribed and sworn to before me this 12th day o
June, 1955.

C. J. Bergen

Notary Public
Salt Lake City, Utah

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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 148

WESLEY F. MULLETT, FRANK J. MULLETT, HAROLD COMER, AND LEO WEIBEL, PETITIONERS

v.

WILLIAM J. KORTH, INDIVIDUALLY AND AS COLLECTOR OF INTERNAL REVENUE, DISTRICT OF UTAH

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The District Court wrote no opinion. The opinion of the Court of Appeals (Pet. App. 58–72) is reported at 219 F. 2d 732.

JURISDICTION

The judgments of the Court of Appeals were entered on February 8, 1955 (Supp. R. 20–27). Rehearing was denied on March 16, 1955 (Supp. R. 36). The petition for a writ of certiorari was filed on June 13, 1955. The jurisdiction of this Court is invoked under 28 U. S. C. 1254.

QUESTIONS PRESENTED

1. Whether Section 3 (a) of the Administrative Procedure Act requires that taxpayers be given an opportunity for conference prior to assessment of a tax.

2. Whether the courts below erred in holding that the Collector had sufficiently pleaded fraud.

3. Whether the taxpayer suing for a refund has the burden of establishing the amount he is entitled to recover.

4. Whether the trial court erred in excluding certain testimony.

STATUTES AND REGULATIONS INVOLVED

The relevant statutes, Section 3 (a) of the Administrative Procedure Act, and Sections 2400, 2403, 2408, 2410, 2709 and 3312 of the Internal Revenue Code of 1939, and Sections 320.70 and 320.72 of Treasury Regulations 51, will be found in the Appendix, *infra,* pp. 12–16.

STATEMENT

The following facts which are in the main not challenged in the petition are summarized from the opinion of the Court of Appeals (Pet. App. 58–72).

These four consolidated cases involve the assessment of excise tax deficiencies and fraud penalties for the years 1942, 1943, and 1944. Each of the taxpayers was engaged in the jewelry business during the years in question. Wesley F. Mullett operated a store in Cedar City, Utah; Frank

Mullett operated one store and was a partner in another in Provo, Utah; Harold Comer operated a store in Logan, Utah; Leo Weibel operated a store in St. George, Utah (Pet. App. 58–59).

Wayne Decker largely financed these jewelry businesses. He operated his own jewelry business in Salt Lake City and kept the books and records for all the stores and prepared most of the excise tax returns filed by taxpayers for the years in question (Pet. App. 59).

The records were incomplete and fragmentary. Taxpayers sent information to Decker once or twice a month, generally consisting of summaries of sales, amount of cash received, certain payments, and occasionally cancelled checks and breakdowns on excises and sales taxes. The records kept by Decker consisted only of ledger accounts and contained only monthly entries and annual totals for each store. Decker destroyed the information reports sent him by taxpayers. They retained no copies, with one exception, and in that case the summarized list did not contain all the sales (Pet. App. 63–64).

Complete sales tickets for one full year were available only from one store, for 1943. The sales shown on these tickets were considerably in excess of the sales shown on Decker's books. In many instances merchandise sales were shown as repairs, not subject to excise taxes. Sales shown for the years after the tax investigation began, in 1945, were considerably in excess of those shown

for the years in question. Bank deposits made solely from business profits showed that the business had larger profits than was shown in Decker's books. The inventories reported for the years following the investigation were many times greater than for the years in question (Pet. App. 64).

The Collector reconstructed the sales and computed the tax thereon by applying to the cost of goods sold as reflected by taxpayer's books a mark-up percentage obtained from an examination of those sales tickets which were available. The Court of Appeals held this method to be inaccurate to the extent that it did not allow something for shrinkage, i. e., freight and handling cost, and merchandise which was stolen, broken, lost, given away, or eliminated from inventory. The court, however, held that taxpayers had greatly understated their total actual sales; that taxpayers had completely failed to establish the amount of shrinkage; and that accordingly they had failed to show the amount they were entitled to recover in this action (Pet. App. 64–66).

The investigation of these businesses was begun by the Collector in the spring of 1945. Sworn statements were secured from all of the taxpayers and from Decker. All stated that the businesses were partnerships with Decker as a partner. As a result of the investigation, notices and demands for additional excise taxes, penalties, and interest were mailed to Decker on February 12, 1948. After a delay at his request, the same forms were

again sent to him on July 13, 1948. Decker then sought to enjoin the collection of the taxes from him on the ground that he was not a partner and did not owe the taxes. The United States District Court entered a temporary restraining order with the suggestion that the Government attempt to collect the taxes from the other taxpayers. On December 9, 1948, notices and demands were sent to the four taxpayers, who paid them from funds furnished by Decker. Claims for refund were filed and, the claims not having been honored, in due course these actions were filed to recover the amounts so paid (Pet. App. 59–61).

The Collector affirmatively asserted the defense of fraud for the tax years involved, alleging specifically for 1942 and 1943 that no monthly partnership returns were filed as required by law, reporting the taxes due on the sales of jewelry; that returns for certain months were not verified as required by law; that taxpayers willfully and knowingly attempted to defeat and evade a large part of the taxes due by failing to file certain returns and by filing false and fraudulent returns; that taxpayers knowingly reported their taxable sales as being considerably less than actual sales; that the true picture of taxable sales was distorted because substantial costs of sales were shown on taxpayers' books as cost of repairs and that Decker knowingly and willfully failed to keep proper and adequate books for the partnership businesses. The Collector's answers did not

specifically plead these facts of fraud for the year 1944 but contained somewhat more general allegations of fraud. The evidence on which the Collector relied to establish fraud was introduced in evidence and the trial court ruled that the pleadings could be amended to conform to the proof (Pet. App. 62, 69).

The trial court excluded certain evidence by taxpayer Comer and certain evidence by taxpayers' accountant, Pinnock. The Court of Appeals, holding that this was not error, stated: the only part of Comer's testimony that was excluded was that wherein he attempted to explain accounting procedure employed by someone else in keeping books, of which he manifestly had no personal knowledge; Pinnock was restricted only when he undertook to draw conclusions from facts not in the record; and the testimony along the line of accounting procedure referred to non-factual self-serving conclusions based entirely upon speculation (Pet. App. 67–68).

ARGUMENT

1. Taxpayers' argument (Pet. 7) that the publication provision of Section 3 (a) of the Administrative Procedure Act (Appendix, *infra*, p. 12) requires that the Collector must in all cases have conferences with taxpayers before assessing taxes is completely without merit. That taxpayers have misconceived the scope and purpose of the requirement of publication of administrative rules

and procedures is evident from their suggestion that if a statutory provision is procedural it too must be published in the Federal Register to be valid (Pet. 10). Since in fraud cases 26 U. S. C. 3312 (b) permits assessment without notice, or suit without assessment, the ordinary procedures published in the Federal Register and providing for conferences at the request of the taxpayer are obviously not mandatory.

Petitioners' argument (Pet. 6–7) that the failure to follow published procedures makes the assessment void is unsound. Even if the procedure here in question were applicable to fraud cases, failure to issue the preliminary letters and to permit conferences does not void the assessment. Section 3 (a) of the Administrative Procedure Act, in stating that "No person shall in any manner be required to resort to organization or procedure not so published" relieves persons of the duty of complying with unpublished regulations but does not thereby invalidate all subsequent proceedings. The obvious purpose of this section is to insure that persons dealing with the Government shall not be prejudiced or foreclosed from asserting their rights by their failure to resort to administrative remedies or procedures not made known to them. Here taxpayers were not prejudiced, despite their unsupported assertion (Pet. 13) that they could have obtained an administrative settlement of these taxes at 10%

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of the total amount. They have not been foreclosed from asserting their claims for refund, either administratively or in the present actions.

The decision of this Court in *Wong Yang Sung* v. *McGrath*, 339 U. S. 33, referred to by taxpayers (Pet. 10–11) involved minimum requirements for fairness in administrative hearings. It has no relation to the requirement for publication of procedures.

2. Taxpayers cite several cases applying Rule 9 (b) of the Federal Rules of Civil Procedure, which requires that facts constituting fraud must be pleaded with particularity (Pet. 18–22, 32) and assert a conflict with those decisions. Since the courts below properly applied that rule, there is no conflict of decisions.

Taxpayers' argument has special application to the third year involved, 1944. It is true that with respect to the years 1942 and 1943, paragraph 12 of each answer, as finally amended (R. 23, 28–32, 45, 50–55, 68, 72–75, 87, 91–94), makes specific factual allegations of fraudulent acts for the specified purpose of meeting the extended statute of limitations existing where fraud is involved. However, there are also in paragraph 15 of each answer, separate factual allegations of fraud with respect to the year 1944 (R. 25–26, 48, 70–71, 89–90). Although these allegations are less detailed than those for the years 1942 and 1943, the court below found them adequate to give the taxpayers notice of the nature of the fraud

alleged. Actually, the evidence introduced was of much the same nature as that involved for the earlier years, and it is obvious that the taxpayers could not have been surprised.

3. While recognizing that there was some inaccuracy in the Collector's calculation of the amount of sales because of his failure to allow for shrinkage, the courts below applied the well settled rule that in a suit for refund the taxpayer not only must show that the Collector was wrong but also must go further and establish the essential facts from which a correct determination of his tax liability can be made. The burden is on the taxpayer to establish the amount to which he is entitled.

This rule has been uniformly applied by the Courts of Appeals (see *Taylor* v. *Commissioner*, 70 F. 2d 619 (C. A. 2d), affirmed, 293 U. S. 507; *Forbes* v. *Hassett*, 124 F. 2d 925, 928 (C. A. 1st); *Harvey* v. *Early*, 189 F. 2d 169, 171 (C. A. 4th); *United States* v. *Pfister*, 205 F. 2d 538, 542 (C. A. 8th); *Maroosis* v. *Smyth*, 187 F. 2d 228, 232 (C. A. 9th), certiorari denied, 342 U. S. 814), and has been approved by this Court (*Helvering* v. *Taylor*, 293 U. S. 507, 514).

Taxpayers request a reconsideration of this rule on the ground that it is difficult to maintain records of shrinkage. It has been long established, however, that the burden is on taxpayers to maintain adequate records (*Bergdoll* v. *Pollock*, 95 U. S. 337) and that the inability of a tax-

payer to establish his claim is no ground for allowing it (*Burnet* v. *Houston,* 283 U. S. 223, 228). This case, where not only the records to prove shrinkage were inadequate but all of the records to prove actual sales were incomplete and unreliable, furnishes no occasion for questioning the soundness of the rule.

4. Taxpayers here repeat their objection made in the court below to the exclusion of certain testimony.

Some of the testimony was by Comer (Pet. 40–42) as to how his gross profit was determined. The Court of Appeals correctly pointed out (Pet. App. 67–68) that the only part excluded was that wherein he attempted to explain accounting procedure employed by someone else in keeping books of which he manifestly had no personal knowledge. This holding was amply supported by Comer's own statement that he did not know how his gross profit was determined, that it was done by Decker in Salt Lake City, that Decker kept the books, and that Comer did not know how to keep books (R. 156).

Other testimony was offered by taxpayers' accountant. The Court of Appeals pointed out that he was restricted only when he undertook to draw conclusions from facts not in the record and that the testimony referred to nonfactual self-serving conclusions based entirely on speculation (Pet. App. 68). This was fully justified by the accountant's admissions that he started with the

premise that the books kept by Decker were accurate (R. 228), although bank deposits exceeded receipts (R. 228), that he reconstructed the amount of taxable sales merely by multiplying the actual tax paid by ten (R. 229) and that he estimated shrinkage with no supporting data and he did not know what the facts were (R. 229).

The alleged errors in excluding testimony are not such as to call for the interposition of this Court, even if the exclusion were shown to be erroneous. In fact, however, the courts below were correct in their rulings.

CONCLUSION

The decision below is not in conflict with the decision of any other Court of Appeals; it is in accord with the applicable decisions of this Court; and it presents no question of general applicability. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JULY 1955.

APPENDIX

Administrative Procedure Act, c. 324, 60 Stat. 237:

SEC. 3. Except to the extent that there is involved (1) any function of the United States requiring secrecy in the public interest or (2) any matter relating solely to the internal management of an agency—

(a) *Rules.*—Every agency shall separately state and currently publish in the Federal Register (1) descriptions of its central and field organization including delegations by the agency of final authority and the established places at which, and methods whereby, the public may secure information or make submittals or requests; (2) statements of the general course and method by which its functions are channeled and determined, including the nature and requirements of all formal or informal procedures available as well as forms and instructions as to the scope and contents of all papers, reports, or examinations; and (3) substantive rules adopted as authorized by law and statements of general policy or interpretations formulated and adopted by the agency for the guidance of the public, but not rules addressed to and served upon named persons in accordance with law. No person shall in any manner be required to resort to organization or procedure not so published.

* * * * *

(5 U. S. C. 1002.)

Internal Revenue Code of 1939:

SEC. 2400 [as added by Sec. 552 (a) of the Revenue Act of 1941, c. 412, 55 Stat. 687]. TAX ON JEWELRY, ETC.

There is hereby imposed upon the following articles sold at retail a tax equivalent to 10 per centum of the price for which so sold: All articles commonly or commercially known as jewelry, whether real or imitation; pearls, precious and semi-precious stones, and imitations thereof; articles made of, or ornamented, mounted or fitted with, precious metals or imitations thereof; watches and clocks and cases and movements therefor; gold, gold-plated, silver, silver-plated or sterling flatware or hollow ware; opera glasses; lorgnettes; marine glasses; field glasses; and binoculars. * * *

(26 U. S. C. 2400.)

SEC. 2403 [as added by Sec. 552 (a) of the Revenue Act of 1941, *supra*]. RETURN AND PAYMENT OF RETAILERS' EXCISE TAXES.

(a) Every person who sells at retail any article taxable under this chapter shall make monthly returns under oath in duplicate and pay the taxes imposed by this chapter to the collector for the district in which is located his principal place of business or, if he has no principal place of business in the United States, then to the collector at Baltimore, Maryland. Such returns shall contain such information and be made at such times and in such manner as the Commissioner, with the approval of the Secretary, may by regulations prescribe.

(b) The tax shall, without assessment by the Commissioner or notice from the collector, be due and payable to the collector at

the time so fixed for filing the return. If the tax is not paid when due, there shall be added as part of the tax interest at the rate of 6 per centum per annum from the time when the tax became due until paid.

* * * * *

(26 U. S. C. 2403.)

SEC. 2408 [as added by Sec. 552 (a) of the Revenue Act of 1941, *supra*]. APPLICABILITY OF ADMINISTRATIVE PROVISIONS.

All provisions of law (including penalties) applicable in respect of the taxes imposed by section 2700 shall, insofar as applicable and not inconsistent with this chapter, be applicable in respect of the taxes imposed by this chapter.

(26 U. S. C. 2408.)

SEC. 2410 [as added by Sec. 552 (a) of the Revenue Act of 1941, *supra*]. RULES AND REGULATIONS.

The Commissioner, with the approval of the Secretary, shall prescribe and publish all needful rules and regulations for the enforcement of this chapter.

(26 U. S. C. 2410.)

SEC. 2709. RECORDS, STATEMENTS, AND RETURNS.

Every person liable to any tax imposed by this subchapter, or for the collection thereof, shall keep such records, render under oath such statements, make such returns, and comply with such rules and regulations, as the Commissioner, with the approval of the Secretary, may from time to time prescribe.

(26 U. S. C. 2709.)

SEC. 3312. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

* * * * *

(a) *General Rule.*—All internal revenue taxes shall (except as provided in subsections (b), (c), and (d)) be assessed within four years after such taxes became due, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of five years after such taxes became due.

(b) *False Return or no Return.*—In case of a false or fraudulent return with intent to evade tax, or of a failure to file a return within the time required by law, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

(c) *Willful Attempt to Evade Tax.*—In case of a willful attempt in any manner to defeat or evade tax, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

* * * * * *

(26 U. S. C. 3312.)

Treasury Regulations 51, promulgated under the Internal Revenue Code of 1939:

SEC. 320.70 [as renumbered by T. D. 5353, 1944 Cum. Bull. 597] *Returns.*—Each person required to report a tax on the sale of any of the articles covered by these regulations must make a return on Form 728A in accordance with the instructions thereon. The return must be made in duplicate under oath for each calendar month and must be verified before an officer duly authorized to administer oaths. * * *

* * * * * *

SEC. 320.72 [as renumbered by T. D. 5353, *supra*] *Records.*—Every person required to file a return and pay tax on the sale of an article at retail, shall keep on file at his principal place of business, or some other convenient or safe location, accurate records and accounts of all transactions. * * *

The records shall contain sufficient information to enable the Commissioner to determine whether the correct amount of tax has been paid. Such records shall at all times be open for inspection by internal revenue officers, and shall be maintained for a period of at least four years from the date the tax became due or, in the case of tax-free sales, for a period of at least four years from the last day of the month following the month in which the sale was made.

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In the Supreme Court of the United States

OCTOBER TERM, 1955

WESLEY F. MULLETT, FRANK J. MULLETT, HAROLD COMER, AND LEO WEIBEL, PETITIONERS

v.

WILLIAM J. KORTH, INDIVIDUALLY AND AS COLLECTOR OF INTERNAL REVENUE, DISTRICT OF UTAH

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY AND SUPPLEMENTAL BRIEF

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INTRODUCTION

Taxpayers assert that the "Questions Presented" section of the Collector's brief does not correctly state the questions, but narrows and misstates them. Certainly it does not correctly state the issues the taxpayers intended to raise. Compare with Petition P. 2-3.

In his "Statement" the Collector makes a host of glaring misstatements, which would take many pages to expose and refute. Taxpayers have not in their Petition or this Reply attempted to do so because of their belief that this is unnecessary to the presentation of the legal issues involved, and the omission is warranted by the saving of space. Perhaps this is a mistake, as such material seems to have greatly influenced the Circuit Court of Appeals, and the Collector obviously attaches great importance to it. Nevertheless, taxpayers rely on the sound discrimination of this Court, and state only that the Collector's statement (Br. 2) "The following facts which are in the main not challenged . . . " is not true. Those alleged "facts" have been bitterly challenged from the beginning, as the Collector well knows, and were challenged repeatedly in the Petition, both directly and by necessary implication, complete with reference to the record. The taxpayers request the opportunity to refute the Collector's statements in detail and at length in a proper brief, by showing that they are entirely without support in the record, contrary to taxpayers' testimony, and in some cases contrary to the testimony of the Collectors' own witnesses.

ARGUMENT

1. The portion of the Collector's brief advancing the novel argument that the "obvious purpose" of the Administrative Procedure Act (Br. 7) *"is to insure that persons dealing with the Government shall not be prejudiced or foreclosed from*

asserting their rights by their failure to resort to administrative remedies not made known to them" would place a construction upon the Act which would render it totally meaningless and of no effect whatsoever. Since Constitutional due process requires notice, no court would permit a person to be prejudiced by his failure to resort to remedies or procedures of which he had no notice notwithstanding the Act.

Taxpayers contend that the Administrative Procedure Act was passed for broader purposes:

> (1) "One purpose was to introduce greater uniformity of procedure." (*Wong Yang Sung vs. McGrath*, 339 U.S. 33 @ 41, 70 S. Ct. 445 @ 450).
>
> (2) "It created safeguards even narrower than the Constitutional ones." (*U.S. vs. Morton Salt Co.*, 338 U.S. 632 @ 644, 70 S. Ct. 357 @ 364).
>
> (3) "The necessity for prior administrative consideration of an issue is apparent where . . . its decision calls for the application of technical knowledge and experience not usually possessed by judges . . . decisions . . . which involve those difficult problems of policy, accounting, economics and special knowledge . . . " (*Federal Power Comm. vs. Colorado Interstate Gas Co.*, 75 S. Ct. 467 @ 472—March 28, 1955).

Because the law does not permit recourse to the Tax Court in excise tax cases—a court specially qualified to understand accounting procedures—this Court should zealously preserve these taxpayers' rights to administrative remedies in excise tax cases. Further, these taxpayers are not claiming immunity from the necessity of exhausting their administrative remedies as has so often been the case, but they are exhausting themselves and their resources in an effort to secure the administrative procedure prescribed by the Code of Federal Regulations and guaranteed by the Administrative Procedure Act.

The 9th Circuit Court of Appeals in *Hotch vs. U. S.* 212 F. 2d 280 @ 283, said:

> "While the Administrative Procedure Act and the Federal Register Act are set up in terms of making information available to the public, the acts are more than mere recording statutes whose function is solely tc give constructive notice to persons who do not have actual notice of certain agency rules. The Acts set up the procedure which must be followed in order for agency rulings to be given the force of law. Unless the prescribed procedures are complied with, the agency (or administration) rule has not been legally issued, and consequently it is ineffective."
>
> "Therefore, the Administrative Procedure Act and the Federal Register Act must be read as a part of every Congressional delegation of authority, unless specifically excepted."

The Collector's argument here goes far beyond that position stated in *Riss & Co. vs. U. S.* 96 F. Supp. 452, which was rejected and reversed by this Court in a memorandum opinion in 341 U. S. 907, 71 S. Ct. 620, 95 L. Ed. 1345, citing the case of *Wong Yang Sung vs. McGrath,* supra, as controlling.

Although the Collector's argument is a prize bit of double talk (Br. 7), susceptible of several possible meanings, it has no more effect than to re-state the Fifth Amendment and implies that the Act guarantees nothing in the form of admintstrative procedure. The logical conclusion to be drawn from his position is that (1) he may follow procedure which has not been published, or (2) he need follow only portions of published procedure, or (3) he need follow no procedure at all (as in these cases)—so long as the taxpayer is not "prejudiced" or foreclosed from asserting his "rights." As a result "uniformity of procedure" is destroyed and the Collector may dis-

criminate at will among taxpayers as he has done in the parallel cases discussed in the taxpayers' Petition at page 7.

5 U.S.C. 1011 (Pet. App. 50):

> " . . . all requirements or privileges relating to evidence or procedure shall apply equally to agencies and persons."

The Collector states (Br. 7) that taxpayers were not "prejudiced," yet they were forced to pay the entire deficiency assessment and penalties upon threat of distraint, some 4½ years before forcing the Collector into the District Court hearing. They did not receive irregular, unpublished or unfair administrative procedure; they received none at all. The Collector has failed to suggest how taxpayers could have been more prejudiced.

Nor has he pointed out any administrative right or remedy which was not foreclosed, despite the bald assertion to that effect in his brief (Br. 8), and although he admits he failed to give any notice or grant any of the hearings prescribed by the Code of Federal Regulations and repeatedly requested by the taxpayers.

The pleadings before the Tax Court in these taxpayers' corresponding income tax cases (Pet. 13), which set out the assessments and computations on which they were based (with the same method of "redetermining" sales as used herein), and the stipulations worked out in administrative hearings which settled those cases for about 10% of the amount of the dificiencies and penalties, are on file in the Tax Court, subject to the jurisdiction and judicial notice of this Court, and demonstrate that these taxpayers were greatly prejudiced by the Collector's refusal to permit similar administrative hearings in these excise tax cases.

The Collector's argument as to the effect of 28 U.S.C. 3312 (b) has been adequately disposed of in the Petition beginning at page 9.

2. In his argument on Rule 9(b) FRCP, the Collector has made three gross misstatements (Br. 8-9): that the evidence introduced for 1944 was of much the same nature as that involved for the earlier years, that the courts below found the fraud allegations for 1944 adequate under Rule 9(b), and that the courts below properly applied Rule 9(b). On the contrary, the trial court specifically found that Rule 9(b) had not been satisfied and ordered further pleadings, which order admittedly (R. 146) was never complied with, nor was any attempt to amend the pleadings ever made, which would have permitted taxpayers to argue on that issue. The courts below did not apply Rule 9(b) at all, but they applied Rule 15(b) to override and obviate Rule 9(b). The other misstatement is briefly discussed in the Petition p. 15-16, and careful study of the record will show how false the statement is.

3. The Collector's statement that (Br. 9) "Taxpayers request a reconsideration of this rule on the ground that it is difficult to maintain records of shrinkage," is not true. It is not merely "difficult," it is *impossible*. Taxpayers want the opportunity to show to the Court just what "shrinkage" is, what shrinkage records can and cannot be kept, and what effect shrinkage has upon business and business records, by specific example and extensive accounting authority. These cases were based upon the Collector's assumption that direct and itemized shrinkage records can and must be maintained. This is physically impossible. See Petition p. 33-39.

4. The exclusion of testimony is covered in the Petition p. 39-47. Careful analysis of the record will show that the Col-

lector's references are misused, misleading, and limited by qualifications not mentioned by him; and do not support his allegations in any way. For instance, Comer's testimony (R. 156) that he did not know how to keep books in 1942-1944 is cited to show that he did not know how in 1952, although he had had seven years experience by that time. No testimony whatever impeaching the validity of the vital Exhibits at R. 289-297 appears in the record, or suggests a reason why the court should not have allowed accountant Pinnock to thoroughly explain them instead of limiting taxpayers to a brief argument to the jury by legal counsel.

These cases grew out of a misunderstanding and misapplication of accounting principles, and the testimony rejected was refused because of the Court's lack of comprehension of accounting and accounting terminology, which caused it to reject statements of accounting fact as inadmissible "opinions." This forcibly illustrates the wisdom of requiring "administrative consideration of an issue . . . where . . . its decision calls for the application of technical knowledge and experience not usually possessed by judges . . . which involve . . . accounting . . . " (*Federal Power Commission vs. Colorado Interstate Gas Co.*, supra, 75 S. Ct. 467 @ 472, March 28, 1955.)

CONCLUSION

The taxpayers have been denied due process of law through: failure of the Collector to follow the Administrative Procedure Act and Code of Federal Regulations requirements in these cases; failure of the Collector to properly plead fraud; introduction of so-called fraud evidence not within the pleadings; improper application of burden of proof rules; and

improper rejection of testimony. The petition for a writ of certiorari should be granted.

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